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To: Members of the Executive Board

From: The Secretary

Subject: **Draft Manual on Fiscal Transparency**

Attached for consideration by the Executive Directors is a draft manual on fiscal transparency, which is tentatively scheduled for discussion on Monday, August 24, 1998.

Mr. Hemming (ext. 38543) or Mr. Allan (ext. 38542) is available to answer technical or factual questions relating to this paper prior to the Board discussion.

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INTERNATIONAL MONETARY FUND

Draft Manual on Fiscal Transparency

Prepared by the Fiscal Affairs Department

(In consultation with other departments)

Approved by Vito Tanzi

July 31, 1998

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Abbreviations

CBH	Charter of Budget Honesty
CFS	Code of Fiscal Stability
COFOG	Classification of the Functions of Government
EBFs	Extrabudgetary funds
ESA	European System of Accounts
FFC	Financial and Fiscal Commission
FRA	Fiscal Responsibility Act
GDDS	General Data Dissemination System
GFS	Government Finance Statistics
IADB	Inter American Development Bank
IFAC	International Federation of Accountants
INTOSAI	International Organization of Supreme Audit Institutions
MTBF	Medium-term budget framework
NFPEs	Nonfinancial public enterprises
OECD	Organization for Economic Cooperation and Development
PSC	Public Sector Committee (of IFAC)
PFIs	Public financial institutions
PPBS	Planning, Programming, and Budgeting System
PSBR	Public sector borrowing requirement
QFAs	Quasi-fiscal activities
SDDS	Special Data Dissemination Standard
SNA	System of National Accounts
TIN	Taxpayer identification number
UN	United Nations
UNCITRAL	United Nations Commission on International Trade Law

INTRODUCTION

1. At its fiftieth meeting in Washington, D.C., on April 16, 1998, the Interim Committee of the Board of Governors of the International Monetary Fund adopted the Code of Good Practices on Fiscal Transparency—Declaration on Principles.[1] It did so in response to a clear consensus that good governance is of central importance to achieving macroeconomic stability and high-quality growth, and that fiscal transparency is a key aspect of good governance.[2]

2. Fiscal transparency means being open to the public about the structure and functions of government, fiscal policy intentions, *public sector*[3] accounts, and fiscal projections (Kopits and Craig, 1998). Fiscal transparency strengthens accountability and increases the political risk associated with maintaining unsustainable policies. It can therefore enhance credibility, the benefits of which will be reflected in lower borrowing costs and stronger support for sound macroeconomic policies by a well-informed public. In contrast, nontransparent fiscal management can be destabilizing, create inefficiency, and foster inequity. The potential for a fiscal crisis in one country to spill over to others underscores the value of efforts to prevent or anticipate these events. Improved fiscal transparency is a necessary part of such efforts, which must attract the strong support of member countries if they are to succeed.

3. The Code is based on four general principles of fiscal transparency to which all countries should adhere.

- The first general principle—Clarity of Roles and Responsibilities—reflects the importance of clear boundaries within government between fiscal, monetary, and public enterprise activities, and between the public and private sectors. However, the Code does not advocate any particular allocation of responsibility among government agencies.

- The second general principle—Public Availability of Information—is concerned with the need for both comprehensive fiscal information and for governments to commit themselves to publish fiscal information at clearly specified times. The concept of comprehensiveness goes beyond that typically covered in government budget and accounts statements. In particular, the Code emphasizes the need to report on any *quasi-fiscal activities (QFAs)*[4] that have been assigned or otherwise undertaken by nongovernment agencies.

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[1]Henceforth referred to as the Code.

[2]See IMF (1998a).

[3]A number of technical terms are italicized on first usage and defined in Annex IV.

[4]QFAs are discussed in paragraphs 34–39 and 76–79.

- The third general principle—Open Budget Preparation, Execution, and Reporting—encompasses traditional standards relating to the coverage, accessibility, and integrity of fiscal information. Considerable emphasis is placed on the development and harmonization of international statistical and accounting standards for government reporting.

- The fourth general principle—Independent Assurances of Integrity—emphasizes the usual means of providing such assurances through external audit and statistical independence, but then goes beyond this and calls for openness by governments to allow independent scrutiny.

4. The Code also proposes specific principles and good practices corresponding to each of the general principles. The good practices represent a standard for fiscal transparency that most countries should seek to meet. The draft Manual on Fiscal Transparency[5] sets out in more detail these principles and practices, and provides guidance on their implementation. In so doing, it draws on experiences in member countries to illustrate good practices. Because of the complexity of fiscal management systems, the Manual does not provide comprehensive directions on how all the good practices are to be put in place. It does, however, provide numerous references and web site addresses that will assist with the practical implementation of the Code. In preparing the Manual, a number of points have been taken into account.

5. First, the Code is to be implemented on a voluntary basis. The Manual is therefore careful to provide a rationale for the principles and practices included in the Code. Moreover, although most countries follow a number of these principles and practices, the majority of countries will have to make a significant effort to fully implement the Code, and many countries will need considerable time to achieve transparency consistent with the Code. There may also be a need for technical assistance to support individual country efforts.

6. Second, fiscal transparency is only one aspect of good fiscal management, and care is needed to distinguish fiscal transparency from two other key aspects, namely the efficiency of government activity and the soundness of public finances. As the Code notes, attention has to be paid to all three aspects, which are clearly interrelated. But the Code does not advocate institutional changes that would promote efficiency or the maintenance of sound public finances. Thus if agencies outside *general government* engage in QFAs, or fiscal policy objectives are pursued through *extrabudgetary funds* (EBFs)[6] and *tax expenditures*, the Code emphasizes that their role be clearly identified and their financial consequences reported on. However, the expectation is that transparency about QFAs, EBFs, and tax expenditures will provide less incentive for their extensive use and lead to some of them being replaced by more traditional practices of fiscal management.

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[5]Henceforth referred to as the Manual.

[6]EBFs are discussed in paragraph 33.

7. Third, diversity in country backgrounds and capacity constraints to improving fiscal management practices are clearly recognized in both the Code and the Manual. Thus they identify good practices that can be implemented by most countries within a reasonable time frame. The Manual, in addition, identifies best practices in selected areas to which those countries with the most sophisticated and transparent fiscal management systems can reasonably aspire. Also, although the principles and practices are applicable at all levels of government, it is recognized that the application of the Code will have to be limited, at least initially for some countries, to *central government*. The fact that the Code is voluntary, and that some countries will need considerable time to fully implement the Code, is further recognition of diversity and capacity constraints.

8. Fourth, in some areas covered by the Code, there are already international standards that have been developed, or are in the process of development, by the IMF and other organizations. The Code and the Manual are intended to be supportive of these other initiatives. Thus consistency has been maintained with IMF data standards in the fiscal area and public sector accounting standards being developed by the International Federation of Accountants (IFAC). Moreover, transparency in government interactions with the banking sector, as called for by the Code, should increase the effectiveness of banking standards being developed by the Basle Committee on Banking Supervision (1997).

9. Box 1, at the end of this introduction, provides a summary of the fiscal management requirements that constitute the good practices proposed in the Code. These are judged appropriate to provide assurances to the public and to capital markets that a sufficiently complete picture of the structure and finances of government is available so as to allow the soundness of fiscal policy to be reliably assessed. A number of advanced economies have already largely attained, and in some respects exceeded, this standard. For developing countries and countries in transition, however, many of the practices are not in place and the overall requirements listed in Box 1 are therefore formidable. Implementing the Code will involve both assessing the fiscal management system in each country and establishing country-specific priorities for improving fiscal transparency, possibly with technical assistance.

10. It is beyond the scope of the Manual to suggest what should be the priorities for each country. However, Box 1 does identify in bold print a set of requirements that could be viewed as a minimum standard to be given highest priority by those countries that are a long way from meeting the overall standard embodied in the Code. The rationale underlying the minimum standard is that good practices in the area of fiscal reporting are fundamental to effective fiscal management. This being the case, the minimum standard places primary emphasis on the need for comprehensive, reliable, and timely government budget and accounting reports. It also emphasizes other aspects of fiscal management where increased transparency will provide essential support to the goal of achieving effective reporting.

11. Attaining even the minimum standard will require each country to first undertake a detailed assessment of its fiscal management system with a view to identifying specific weaknesses and to preparing plans to improve fiscal transparency. To help gauge how a country's fiscal management practices compare with those proposed in the Code, the IMF has

developed a questionnaire and a summary report on fiscal transparency. The blank questionnaire and summary report are to be made available on a Fiscal Transparency Home Page, which is being created on the IMF external web site (http://www.imf.org/). This Home Page will also provide access to the Code and the Manual. The latter can be searched by key words to facilitate completion of the questionnaire. An electronic mailbox (fisctran@imf.org) will allow questions about fiscal transparency in general, and the questionnaire in particular, to be addressed to IMF staff.

12. The expectation is that country authorities will be interested in completing the questionnaire and summary report primarily as a basis for developing country-specific plans to increase fiscal transparency. However, the general public can access the Home Page, the intention being to provide a medium through which better fiscal management practices can be promoted by any interested party. Other organizations, such as the Organization for Economic Cooperation and Development (OECD), the World Bank, and the regional development banks, which share the IMF's interest in issues related to fiscal transparency, are likely to find the material on the Home Page useful. In this connection, it is important that there be cooperation between various organizations to ensure that the resources devoted to promoting fiscal transparency and supporting country efforts to increase fiscal transparency are used efficiently. Thus the OECD could focus on those aspects of the Code more relevant to its advanced economy membership; the World Bank could emphasize the developmental and more microeconomic aspects of the Code; and the regional development banks, with their geographical perspective, could play a role in tailoring the Code to the different circumstances of their membership.

13. The provision of technical assistance also needs to be carefully coordinated. The Manual, the questionnaire, and the summary report are intended to help countries identify priority areas where fiscal transparency can be increased. In the process, they will also help identify where technical assistance is needed. A significant part of IMF-provided technical assistance is already directed toward improving fiscal management and budgetary processes. With the availability of the Code and the Manual, which will raise the profile of fiscal transparency issues, the effectiveness of this technical assistance, both in its provision and its utilization, should improve. However, some increase in the demand for technical assistance is inevitable, and the IMF will work with other providers to ensure that efforts are not duplicated.

14. The remainder of the Manual is organized as follows. Sections I–IV provide guidelines for the implementation of the principles and practices of fiscal transparency included in the Code. The questionnaire and summary report are provided in Annexes I and II, respectively;[7] Annex III is a consolidated summary of international standards related to fiscal transparency. Annex IV is a glossary of technical terms and Annex V is a list of web sites referred to in the Manual. As with the Code, the Manual will be subject to periodic revision as fiscal management priorities evolve.

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[7]Both the questionnaire and summary report are blank. The **United Kingdom** authorities have published a summary almost identical to that in Annex II to assess compliance with the Code (United Kingdom, H.M. Treasury, 1998).

Box 1. Good Practices of Fiscal Transparency—Summary of Detailed Requirements[8]

I. Clarity of Roles and Responsibilities	
1.1 The government sector should be clearly distinguished from the rest of the economy, and policy and management roles within government should be well defined.	
1.1.1 The boundary between the government sector and the rest of the economy should be clearly defined and widely understood. The government sector should correspond to the general government, which comprises the central government and lower levels of government, including extrabudgetary operations.	*Institutional table currently prepared for the Government Finance Statistics Yearbook to be updated regularly (paragraph 17).* ***General government to be defined as in the SNA/GFS*** *(paragraph 18).*
1.1.2 Government involvement in the rest of the economy (e.g., through regulation and equity ownership) should be conducted in an open and public manner on the basis of clear rules and procedures, which are applied in a nondiscriminatory manner.	*Regulation of the nonbank private sector to be based on clear policy goals. Consideration to be given to alternative forms of intervention. Nondiscriminatory application, appropriate division of regulatory responsibility, and periodic reviews are also important (paragraph 21).* *Government involvement in banks to be based on clear policy goals (paragraph 23).* ***Government equity holdings to be identified,*** *rationale for government involvement explained, and a level playing field applied (paragraph 24).*
1.1.3 The allocation of responsibilities between different levels of government, and between the executive branch, the legislative branch, and the judiciary, should be clearly defined.	*Distribution of tax powers and expenditure responsibilities—reflecting stable principles and formulae—to be clearly stated (paragraph 26).* *Roles of different branches of government to be clearly defined in constitutional or administrative law (paragraph 27).*

[8]This box provides a summary of the fiscal management requirements that constitute the good practices proposed in the Code of Good Practices on Fiscal Transparency. Identified in bold print is a set of requirements that could be viewed as a minimum standard to be given highest priority by those countries that are a long way from meeting the overall standard embodied in the Code. The minimum standard places primary emphasis on the need for comprehensive, reliable, and timely government budget and accounting reports.

1.1.4 Clear mechanisms for the coordination and management of budgetary and extrabudgetary activities should be established, and well-defined arrangements vis-à-vis other government entities (e.g., the central bank, and state-controlled financial and nonfinancial enterprises) should be specified.	*Fiscal management responsibilities to be specified to assure adequate control over public finances.* ***The budget to be broadly defined, with extrabudgetary and externally financed activities integrated into the annual budget process and reporting*** *(paragraphs 29–33).* ***Central bank QFAs and full details of central bank profits and losses to be identified*** *(paragraph 36).* ***QFAs by PFIs and information on connected lending and nonperforming loans to be identified*** *(paragraph 38).* ***QFAs by NFPEs to be identified.*** *Noncommercial activities of NFPEs to be identified. Privatization process (also for PFIs) to be transparent (paragraphs 39–41).*
1.2 There should be a clear legal and administrative framework for fiscal management.	
1.2.1 Fiscal management should be governed by comprehensive laws and administrative rules applying to budgetary and extrabudgetary activities. Any commitment or expenditure of government funds should have a legal authority.	*Detailed budget law or administrative framework to be prepared. Accounting, reporting, and auditing procedures to be designed so as to prevent misuse of supplementary budgets, contingency funds, and accumulation of arrears (paragraphs 43–46).*
1.2.2 Taxes, duties, fees, and charges should have an explicit legal basis. Tax laws and regulations should be easily accessible and understandable, and clear criteria should guide any administrative discretion in their application.	*Taxation to be under authority of law. Opportunities for discretionary action by officials to be limited, with procedural safeguards. Laws to be understandable with explanatory materials, up-to-date and accessible. Taxpayers' rights to be clearly stated, with a well-functioning system of administrative review (paragraphs 47–57).*
1.2.3 Ethical standards of behavior for public servants should be clear and well-publicized.	*Basic code of ethical conduct for public servants to be established (paragraph 58).*

II. PUBLIC AVAILABILITY OF INFORMATION	
2.1 The public should be provided with full information on the past, current, and projected fiscal activity of government.	
2.1.1 The annual budget should cover all central government operations in detail, and should also provide information on central government extrabudgetary operations. In addition, sufficient information should be provided on the revenue and expenditure of lower levels of government to allow a consolidated financial position for the general government to be presented.	***Reporting on all extrabudgetary activities and government fee-for-service operations to be included in budget and accounting reports*** *(paragraph 61).* *Ex post information to be provided on general government. Estimates for general government to be presented with central government budget when intergovernmental fiscal relations are significant (paragraph 65).*
2.1.2 Information comparable to that in the annual budget should be provided for the outturns of the two preceding fiscal years, together with forecasts of key budget aggregates for the two years following the budget.	*Original and revised budget aggregates for the two years preceding the budget and forecasts for the two following years to be presented with the budget. Year-to-year changes in classification or presentation to be disclosed, together with their rationale and fiscal consequences (paragraph 66).*
2.1.3 Statements should be published with the annual budget giving a description of the nature and fiscal significance of contingent liabilities, tax expenditures, and quasi-fiscal activities.	***Annual budget to include statements covering the central government's outstanding contingent liabilities, all tax expenditures, and QFAs of the central bank, PFIs, and NFPEs. Such statements to describe the various provisions and their justification, and, where possible, provide some quantification of their actual and potential fiscal significance, both in aggregate and for major components of such programs*** *(paragraphs 67–79).*
2.1.4 The central government should regularly publish information on the level and composition of its debt and financial assets.	***Level and composition of debt (classified as indicated in text) to be reported at least annually, within one to two quarters of the reference period*** *(paragraph 82).* *Financial assets to be reported at the same intervals as debt (paragraph 87).* *Valuation methods, special characteristics of particular instruments, excluded items, and debt arrears to be disclosed (paragraphs 81, 84).*

2.2 A public commitment should be made to the timely publication of fiscal information.	
2.2.1 Specific commitments should be made to the publication of fiscal information (e.g., in a budget law).	***Statement of reporting practices to be published, preferably embodied in law or with a commitment to international standards*** *(paragraph 90).*
2.2.2 Advance release date calendars for fiscal reporting to the public should be announced.	***Calendars to be announced for the year ahead, showing no-later-than release dates for annual reports and a range of dates for more frequently released reports*** *(paragraph 93).*
III. OPEN BUDGET PREPARATION, EXECUTION, AND REPORTING	
3.1 Budget documentation should specify fiscal policy objectives, the macroeconomic framework, the policy basis for the budget, and identifiable major fiscal risks.	
3.1.1 A statement of fiscal policy objectives and an assessment of sustainable fiscal policy should provide the framework for the annual budget.	***A fiscal and economic outlook paper to be published with the budget, including a statement of fiscal policy objectives and priorities, an outline of the economic outlook, and a qualitative assessment of fiscal sustainability*** *(paragraphs 97, 98–103).* *Fiscal aggregates to be projected at least two years beyond the budget year (paragraphs 97, 100).*
3.1.2 Any fiscal rules that have been adopted (e.g., a balanced budget requirement and borrowing limits for lower levels of government) should be clearly specified.	*Any fiscal rules to be clearly explained. Reporting on performance relative to rules to be consistent with other practices in the Code (paragraph 104).*
3.1.3 The annual budget should be presented within a comprehensive and consistent quantitative macroeconomic framework, and the economic assumptions and key parameters (e.g., effective tax rates) underlying budget estimates should be provided.	***Clear statement to be made of the medium-term macroeconomic framework and the macroeconomic forecasts on which the budget is based. Key forecasting assumptions to be reported*** *(paragraph 105).*

3.1.4 Existing commitments should be distinguished from new policies included in the annual budget.	*Summary statement of all policy changes being introduced and their expected fiscal effects to be included in the budget documents (paragraph 106).*
3.1.5 Major risks to the annual budget should be identified and quantified where possible, including the variations in economic assumptions and the uncertain costs of specific expenditure commitments (e.g., financial restructuring).	***Statement of fiscal risks presented with the budget, including effects of variations in assumptions in macroeconomic, revenue and expenditure forecasts, items not yet included in forecasts because of uncertainty, and contingent liabilities** (paragraph 107).*
3.2 Budget estimates should be classified and presented in a way that facilitates policy analysis and promotes accountability.	
3.2.1 Government transactions should be on a gross basis, distinguishing revenue, expenditure and financing, and classifying expenditures on an economic and functional basis. In addition, expenditure should be classified by administrative category. Data on extrabudgetary operations should be similarly classified. Budget data should be presented in a way that allows international comparisons.	***Budget and accounts classification system to cover all government funds. Distinctions to be made at a transactions level to permit generation of GFS-consistent reports. Transactions to be recorded on a gross basis and classified to distinguish basic fiscal aggregates** (paragraph 110).* ***Classification system to facilitate a clear tracing of responsibility for the collection and use of public funds** (paragraph 112).*
3.2.2 A statement of objectives to be achieved by major budget programs (e.g., improvement in relevant social indicators) should be provided.	*Objectives of government programs identified in a way that facilitates comparison with outputs and outcomes (paragraph 114).*

3.2.3 The overall balance of the general government should be a standard summary indicator of the government's financial position. It should be supplemented by other fiscal indicators (e.g., operational balance, structural balance and primary balance) when economic circumstances make it inappropriate to base judgements about fiscal policy stance on the overall deficit alone.	***Analysis of the government's fiscal position to be based on the overall balance*** *(paragraphs 115–16).* *Overall balance to be supplemented by operational balance where inflation is high, the structural balance where the effects of cyclical fluctuation or exogenous shocks in the overall balance are large, and the primary balance where there is substantial public debt (paragraph 116).* *Where QFAs (and other balance sheet operations) are extensive and quantifiable, an augmented fiscal balance to be estimated (paragraph 117).* *Where transactions in financial assets are large, underlying balance to be reported (paragraph 118).* ***Overall balance to be presented in the budget documents with an analytical table showing its derivation from budget estimates*** *(paragraph 121).*
3.2.4 The annual budget and final accounts should include a statement of the accounting basis (i.e., cash or accrual) and standards used in the preparation and presentation of budget data.	***Statement of accounting standards to be presented with the budget, including the basis of recording and reporting (e.g., cash or accrual), definition of the reporting entity, and any exclusions from coverage. Disclosure to be made of any recent or planned changes in accounting policies*** *(paragraph 122).*
3.3 Procedures for the execution and monitoring of approved expenditures should be clearly specified.	
3.3.1 A comprehensive, integrated accounting system, should be established. It should provide a reliable basis for assessing payments arrears.	*Accounting system to have internal controls in conformity with INTOSAI guidelines. Capability to produce reliable reports on arrears, to include externally financed transactions, to maintain records on aid-in-kind, and to encompass balance sheet transactions (paragraphs 124–35).*

3.3.2 Procedures for procurement and employment should be standardized and accessible to all interested parties.	*Regulations governing government purchasing to be clear and accessible. Tenders for contracts above a threshold size to be in conformity with an internationally recognized standard (paragraphs 136–37).* *Procedures on employment in public service to be clearly specified, with merit-based competition for vacancies (paragraph 138).*
3.3.3 Budget execution should be internally audited, and audit procedures should be open to review.	*Internal audit procedures to be clear and accessible. Procedures to be open to review by external auditors (paragraph 139).*
3.4 Fiscal reporting should be timely, comprehensive, reliable, and identify deviations from the budget.	
3.4.1 During the year, there should be regular, timely reporting of budget and extrabudgetary outturns, which should be compared with original estimates. In the absence of detailed information on lower levels of government, available indicators of their financial position (e.g., bank borrowing and bond issues) should be provided.	*Fiscal position to be reported to the legislature at least mid-year. Actual results to be compared to forecasts for the period, and an estimate made of expected year-end fiscal outturn (paragraphs 142–43).* ***GDDS standards of periodicity and timeliness for central government reports (each quarter within a quarter) to be followed** (paragraph 143).* *Aggregate mid-year summary statement of the fiscal position of subnational government to be provided where subnational fiscal issues are significant and practical considerations permit (paragraph 144).*
3.4.2 Timely, comprehensive, audited, final accounts of budget operations, together with full information on extrabudgetary accounts, should be presented to the legislature.	***Rigorous standards of coverage and reliability to be applied to final accounts, which are to be reconciled with budget appropriations and audited by an independent external auditor. Central government audited accounts to be presented to the legislature within 12 months after year-end.** Central government to present a reliable summary of the general government fiscal outturn (paragraph 145).*
3.4.3 Results achieved relative to the objectives of major budget programs should be reported to the legislature.	*Outputs and outcomes of government programs to be monitored against the objectives and publicly reported (paragraph 146).*

IV. INDEPENDENT ASSURANCES OF INTEGRITY	
4.1 The integrity of fiscal information should be subject to public and independent scrutiny.	
4.1.1 A national audit body, or equivalent organization, should be appointed by the legislature, with the responsibility to provide timely reports to the legislature and public on the financial integrity of government accounts.	*Procedures for the appointment of the chief auditor and for his or her removal from office to be independent of the executive (paragraph 152).* ***Mechanisms ensuring that audit findings are addressed to be implemented*** *(paragraph 153).* *Procedural mechanisms assuring legislative oversight of the operation of the office to be implemented (paragraph 154).* ***Standards of audit practice to be consistent with international standards*** *(e.g., INTOSAI) (paragraph 155).*
4.1.2 Macroeconomic forecasts (including underlying assumptions) should be available for scrutiny by independent experts.	***Working methods and assumptions used in producing macroeconomic forecasts to be made publicly available*** *(paragraph 157).*
4.1.3 The integrity of fiscal statistics should be enhanced by providing the national statistics office with institutional independence.	*The UN Fundamental Principles of Official Statistics to be observed (paragraph 159).* *National statistics office to be independent in technical matters (paragraph 159).* *Standards of data integrity and quality in the IMF's GDDS to be observed (paragraph 160).*

I. Clarity of Roles and Responsibilities

15. Establishing clear roles and responsibilities for government is a key aspect of fiscal transparency, which lends credibility to statements on fiscal policy and provides a basis on which accountability for fiscal action can be assigned. Principles and practices in this regard relate to the functions of government and the framework for fiscal management.

The Government Sector

1.1 The government sector should be clearly distinguished from the rest of the economy, and policy and management roles within government should be well defined.

16. Good practices in four areas are covered under this principle: (1) the definition of the government sector; (2) government involvement in the rest of the economy; (3) the allocation of responsibilities within government; and (4) coordination and management of government activities.

17. Defining the boundaries of government is a complex task, and one that is particularly challenging for countries in transition. To help achieve a basic level of clarity in the description of the structure of government, it is recommended that all countries regularly update the institutional table currently prepared for the annual *Government Finance Statistics Yearbook*. This table shows central government units, central government units with individual budgets, and local government. At present, these tables are neither comprehensive nor up-to-date, but with relatively little effort by most countries, they could provide a reasonably clear and publicly available description of the structure of government among IMF members.

Definition of the government sector

1.1.1 The boundary between the government sector and the rest of the economy should be clearly defined and widely understood. The government sector should correspond to the general government, which comprises the central government and lower levels of government, including extrabudgetary operations.

18. The Code focuses on the operations of the general government. As a minimum standard, it is proposed that government activities be defined as in the System of National Accounts, 1993 (SNA)[9] This covers predominantly noncommercial activities of government at all levels, including those activities carried out through EBFs, which facilitates an assessment of fiscal policy for all levels of government taken together.

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[9]Broadly similar to the present *IMF Manual on Government Finance Statistics (GFS) (1986)*; the proposed revision will align completely with the SNA. Social security funds would be considered in relation to the level of government at which they are established (which is one of the two alternatives proposed in the SNA; the other treats social security as a subsector of general government irrespective of the level of government).

19. Although most member countries accept the need to focus on general government, two qualifications should be made. First, some aspects of the Code apply more broadly to the public sector (again, as defined by SNA/GFS), to the extent that nongovernment agencies carry out QFAs. The Code also addresses some aspects of defining the boundary between public sector and private sector activities.[10] Second, it is recognized that there are practical and institutional constraints that may prevent full data on general government from being presented.[11] In such instances, the main focus of the Code should be the central government (and social security funds or other EBFs at that level).

20. Although clarity of boundaries is proposed, the policy question of whether, and to what extent, governments should carry out commercial activities is not addressed; nor is any specific form of institutional separation of commercial and noncommercial activities advocated.

Government involvement in the rest of the economy

1.1.2 Government involvement in the rest of the economy (e.g., through regulation and equity ownership) should be conducted in an open and public manner on the basis of clear rules and procedures, which are applied in a nondiscriminatory manner.

21. The government interacts with other sectors of the economy in a variety of ways, and fiscal transparency may be of limited benefit if there is not a corresponding clarity in other kinds of interactions.

Regulation of the nonbank private sector

22. Direct regulation by government has a pervasive influence on the private sector, and some regulatory measures can be regarded as alternatives to fiscal instruments in that their objectives can also be met by taxes and transfers (e.g., rent control and pollution standards). Governments have become increasingly aware of the need for transparency in regulatory practices. General regulatory standards go beyond the scope of the Code, but some characteristics of transparent regulations that would promote transparency are set out in Box 2.[12]

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[10]See paragraphs 21–24.

[11]See paragraphs 26 and 62–65 for further discussion of central and general government issues.

[12]See OECD (1995) and OECD (1997) for additional detail.

Box 2. Characteristics of Transparent Regulations

- Regulations should have clearly identified policy goals; should be expressed in clear, simple terms; and should have a sound legal basis.
- New regulations should be introduced only after consideration of public costs, benefits, and distributional effects, and after comparison with alternative forms of intervention. Public consultation will often be desirable.
- Procedures for applying regulations should be open and nondiscriminatory. They should apply equally to the public and private sectors, and should contain an appeals process.
- Overlapping responsibilities among regulatory authorities should be minimized.
- Regulations and their impact should be reviewed periodically in published reports.

Government intervention in the banking sector

23. The prudential regulation of banks raises many issues, most of which are properly considered in a financial sector context. However, fiscal concerns arise not only because possible bank failures may lead to pressure for budget support, but also because heavy government involvement in the banking sector has been among the causes of banking crises, especially in developing countries. Government involvement in the banking sector should be based on clearly defined policy goals and as clear as possible an identification of QFAs undertaken by the banking sector. QFAs, such as directed lending and requiring banks to hold government bonds at below-market interest rates, have often undermined the profitability of banks. Other problem areas have been inadequate accounting and disclosure practices, and poor incentives for bank owners, managers, and regulators to ensure that risks are managed prudently. Two key elements in addressing these problems are greater transparency in reporting government involvement in the banking system and an appropriate framework for bank regulation.[13]

Direct equity investment

24. Governments also intervene by directly acquiring private equity in companies or commercial banks. As a minimum standard for transparency in this area, it is proposed that government equity holdings be clearly identified. In addition, it is recommended that their

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[13]Reporting of QFAs is discussed in paragraphs 76–79. The IMF is also developing a Code of Good Practices on Financial and Monetary Policies Transparency, which will cover some of these issues. And international standards for financial policies are receiving considerable attention elsewhere, including from the Basle Committee on Banking Supervision (1997).

rationale be documented, that they be clearly explained in the annual budget, and any changes in holdings be highlighted. There should also be a level playing field, that is, government regulations, taxes, and duties should apply independently of the extent of government involvement.

Allocation of responsibilities within government

1.1.3 The allocation of responsibilities between different levels of government, and between the executive branch, the legislative branch, and the judiciary, should be clearly defined.

25. A clear demarcation of roles within government is essential for transparency. At the broadest level, it is necessary to define the allocation of tax powers and expenditure responsibilities between national and subnational governments and, at each level, the fiscal role of the executive and legislative branches. This is often done at the level of constitutional law.

National and subnational governments

26. The relationship between national and subnational governments varies widely among countries: from federations in which individual states or provinces have relatively strong powers, through federal structures with a relatively strong central government, to unitary forms of government. Precise distributions of tax powers and expenditure responsibilities vary accordingly. Fiscal transparency requires that such powers and responsibilities should be clearly stated and openly executed. They should not be subject to ad hoc annual negotiations, but determined according to stable principles and/or agreed formulae.[14] Difficulties in establishing clear intergovernmental fiscal boundaries are often greater in the larger and more diverse countries, particularly in those in the process of economic or political transition. These problems seriously complicate fiscal management because subnational governments can act independently of, and in direct contradiction to, central government. The **Republic of South Africa** has made good progress in establishing a clear framework for intergovernmental relations among its three spheres of government, as illustrated in Box 3.[15]

Roles of the executive, legislative, and judicial branches

27. Relationships between different branches of government are determined at the highest political and legal levels, vary greatly among countries, and are often subject to change as political and administrative systems develop. A number of recent studies show the important

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[14]However, the intergovernmental framework should not be so inflexible as to constrain effective macroeconomic control by central government.

[15]Further information can be obtained through web sites (http://www.finance.gov.za and http:www.sacs.org.za/gov/ffc/home/ffchome.htm).

Box 3. Intergovernmental Relations in the Republic of South Africa

Three elements have been particularly important in the evolution of the intergovernmental system in the **Republic of South Africa**: a formal and intensive process of multiparty negotiations; the constitutional and legal framework; and the Financial and Fiscal Commission (FFC), a body of professionally qualified advisors appointed by the president to advise the government on intergovernmental fiscal matters.

Developing the framework
Multiparty constitutional negotiations to develop the constitution took place in South Africa in 1992, 1993, and 1994. Fiscal relationships between the central and subnational levels of government are a particularly important and sensitive area, characterized by an imbalance of tax powers and expenditure responsibilities between central and provincial governments, and disparities in fiscal capacities among provinces. The national government collects a large proportion of aggregate revenues, whereas its expenditure responsibilities are much smaller.

It was determined that an independent, well-staffed commission was needed to provide high-level technical advice to the government on intergovernmental issues. On April 27, 1994, the interim constitution came into operation and the FFC was created. Appointments to the commission were made by August 1994. The future of the financial and fiscal commission is assured by a constitutional provision as adopted in May 1996 and amended in October 1996.

Constitutional provisions and other legal and administrative steps
The constitution provides that each sphere of government be entitled to an equitable share of revenue raised nationally to enable it to provide basic services and to perform the functions allocated to it. The government is obliged by the constitution to take account of FFC advice and to consult with provincial and local governments.

FFC recommendations are made to the budget council, comprising the minister of finance and members of executive councils responsible for provincial finance. The FFC recommends an equitable division of revenue and other grants, taking into account the functions assigned to each level of government under the constitution and the capacity of each to pay for these functions through its own resources.

After consultation with provincial governments and local government representatives, the minister of finance tables a division of revenue bill, along with the national budget presentation. This bill specifies the constitutionally required equitable share for each level of government and for each individual province, and all other conditional and unconditional grants from the national government.

Principles of intergovernmental shares
In its framework document for intergovernmental fiscal relations in South Africa, the FFC recommended an objective provincial grant formula that includes five monetary components:

- a minimum national standards grant for education and health costs;
- a spillover grant for the cost of academic hospitals;
- a fiscal capacity equalization grant to compensate for tax base differences between the provinces;
- an institutional grant to fund provincial members of executive councils and legislatures; and
- a basic grant allocated to the provinces—based on their population, with extra weight given to the rural population.

This formula is to be phased in over five years. The system is still evolving and major issues remain. The framework that has been established, however, promises to address these issues openly and to provide a stable basis for intergovernmental relations.

influence that budget institutions have on fiscal outcomes.[16] The Code does not, however, promote a particular structure of government that meets the needs of fiscal management. But from the point of view of transparency, it is important that the legislative and judicial branches play an active role in ensuring the availability and integrity of fiscal information. The Code therefore proposes that the role of each branch of government in fiscal management be clearly defined. As a rule, such definitions should be contained in constitutional or administrative law. Again, the fact that these relationships may be emerging or subject to change in many countries has to be acknowledged, and high priority should be given to resolving such issues where they arise.

Coordination and management of government activities

1.1.4 Clear mechanisms for the coordination and management of budgetary and extrabudgetary activities should be established, and well-defined arrangements vis-à-vis other government entities (e.g., the central bank, and state-controlled financial and nonfinancial enterprises) should be specified.

28. Within the executive branch of government at any level, there should be a clear designation of responsibilities for managing the overall public finances. Lack of clarity in the definition of administrative responsibilities can lead to a lack of accountability, poor communications within government, and weak decision making.

Coordination of the fiscal management process

29. Effective fiscal management requires the centralization of authority over the size of the budget. For general government, the nature of control over subnational governments is determined by intergovernmental fiscal relations. Within any level of government, the key issue is the organization of responsibilities among central (e.g., planning, economy, and finance) and spending ministries. Countries approach this in different ways. In those countries with a tradition of development or central planning, responsibilities for fiscal management are divided between the planning or economy ministry (responsible for the capital or development budget) and the finance ministry (responsible for the current budget).[17] Other countries divide responsibilities by making different ministries or departments responsible for different fiscal management functions (e.g., macro-fiscal policy, budgeting, and accounting). Countries also differ in the relative power of central ministries and spending ministries. There is no blueprint for an organizational structure that can be applied universally. However, a country should clearly define fiscal responsibilities among its ministries to ensure adequate control over public

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[16]See, for instance, von Hagen (1992); Alesina and Perotti (1995); and Stein, Talvi, and Grisanti (1998). These studies suggest that fiscal performance in Europe and Latin America is strengthened by budget procedures that include explicit budget constraints, concentrate power in the executive (and, within the executive, in the finance ministry), and are more transparent.

[17]See paragraph 99 for further discussion of the need to integrate capital and current budgets.

finances. These responsibilities should be clearly specified in the legal or administrative framework for the budget.[18]

30. The way in which the term "budget" is defined is crucial. In some countries, the term is restricted to the estimates related to *annual appropriations* of funds by the legislature. This concept, however, may capture only a small proportion of total fiscal transactions. Various kinds of operations may be set up outside the annual appropriations process, and are thus sometimes referred to as "extrabudgetary." Standing legislation may direct funds to particular purposes outside the annual appropriation process, or set up a fund apart from the general fund of government, such as a social security fund. Often there are transfers from the budget to such a fund, and the budget may bear the risk of meeting the fund deficit if revenues are lower or expenditures higher than forecast. Some countries have set up a wide range of funds and earmarked specific taxes for various purposes. Although there may be valid reasons for setting up some funds outside the budget,[19] excessive use of such arrangements can both diminish transparency, and reduce fiscal policy control and flexibility.

31. It is not uncommon for government agencies to be allowed to use revenue from fees and charges directly for expenditure (e.g., hospital fees and charges that are used by the health administration without first being transferred to the general fund of government). User charging is increasingly being used in a number of OECD countries as a means of providing greater control and incentives for managers of agencies. Such arrangements should be reported in gross terms, either in the government budget or as part of the annual reports of the agencies concerned.

32. The relationship between the domestic budget and aid-funded expenditure presents yet another set of issues for many developing countries. Separate processes for determining the allocation of aid funds and other budgetary receipts are often the basis of transparency and control problems. Transparency requires that information on aid-funded expenditures be integrated into budget decision making and reporting.[20]

33. A fundamental feature of transparent fiscal management is that all fiscal activities should be subject to government review and priority setting as part of the annual budget process,[21] and that the outcomes should be open to scrutiny by the legislature and the public. Although some EBFs will be independently managed and under standing legislative authority, this does not mean that they should be immune from periodic review. For example, the new

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[18]This framework is discussed in paragraph 43.

[19]For example, establishing a relationship between individual earmarked contributions and eligibility for social insurance benefits.

[20]Reporting is discussed further in paragraphs 132–33.

[21]Or through more extended reviews linked to medium-term budget targets.

budget laws in **Moldova** and **Latvia** have been drafted to eliminate the concept of extrabudgetary activities by incorporating all such activities as special funds within the annual budget process. As a minimum standard, it is proposed that budget documentation include reporting of all annual budget appropriations, all forms of extrabudgetary activity, and cover both domestic and external sources of funds. Unless otherwise specified, references to "the budget" in the Manual refer to this broad definition.

Separation of fiscal, monetary, and public enterprise management

34. A clear allocation of responsibilities among general government agencies, the central bank, public financial institutions (PFIs), and nonfinancial public enterprises (NFPEs) is essential to ensure that management in each type of agency is held accountable. Fiscal responsibilities should generally be carried out by general government agencies, or by other agencies under a well-defined and transparent arrangement. A corollary is that if the fiscal authorities carry out either banking or commercial functions, the nature of such activities should be transparent.

General government and the central bank

35. The primary responsibility of the central bank should be to achieve monetary objectives. Increasingly, central bank responsibilities are being defined to give them as much autonomy as possible within arrangements that ensure appropriate accountability. In many countries, central bank laws emphasize the operational independence of the central bank and prohibit or restrict its direct financing of the fiscal deficit (as does the Maastricht Treaty for EU members).[22]

36. In some countries, however, particularly countries in transition and developing countries, a number of activities carried out by central banks are quasi-fiscal in nature. QFAs may involve operations related to the financial system (e.g., subsidized lending and directed credit), or operations related to the exchange system (e.g., multiple exchange rates and import deposits).[23] Such operations may be used by governments as a substitute for direct fiscal action, and have similar macroeconomic effects in whichever part of the public sector they are conducted. They need to be considered in assessing the overall fiscal position, and it is proposed that all countries identify and report the extent of central bank QFAs as a minimum standard.[24]

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[22]Although it is still possible for the central bank to buy government securities in the open market, or to influence the demand for such securities in other ways (e.g., by requiring their use in meeting reserve requirements).

[23]Box 9 contains a more complete listing of the different types of QFAs.

[24]Reporting of QFAs is discussed in paragraphs 76–79, and a discussion of how they can be

(continued...)

37. Most central banks transfer to the government part of the profits resulting from their operations.[25] Although open market operations and foreign exchange market intervention affect a central bank's profit and loss account, such profits and losses are the result of the central bank's pursuit of its public policy objectives. Nevertheless, it is important that full information on central bank profits and losses be publicly reported.[26] This is proposed as a minimum standard which will be met primarily through publication of such information in the annual report of the central bank. However, there would also be value in including in the annual central government budget a summary statement of the factors affecting the profits of the central bank and the transfer to the budget.

General government and public financial institutions (PFIs)

38. Many governments set up PFIs to provide assistance of a quasi-fiscal nature to industry, such as a development bank that provides loans to specific sectors at below-market rates. Governments also use PFIs on a more ad hoc basis to provide quasi-fiscal assistance, for example, through policy directions on lending to state-owned financial enterprises. Although privatization of state-owned banks has been increasing, they still account for a dominant share of banking sector assets in many developing economies.[27] Governments may also provide various kinds of loans directly, with varying degrees of expectation of repayment. It is proposed as a minimum standard that the QFAs of PFIs be clearly identified and reported,[28] that there be full reporting by individual PFIs of any lending to other government-owned entities, and disclosure of information on nonperforming loans, as generally required under banking regulations.

General government and nonfinancial public enterprises (NFPEs)

39. NFPEs in many countries are required to carry out QFAs in the form of providing noncommercial services, usually through charging less than cost-recovery prices for specific services (such as providing electricity at below cost to rural consumers). In a number of

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[24](...continued)
incorporated into assessments of the overall fiscal position is contained in Box 15.

[25]Where a central bank makes a loss, especially if such losses result from QFAs, they should, contrary to general practice, be added—for reporting purposes—to central government expenditure to produce an *augmented fiscal balance* (see paragraph 76 for further discussion).

[26]This issue is expected to be covered in the Code of Good Practices in Monetary and Financial Policies Transparency.

[27]See Goldstein (1997).

[28]As discussed in paragraphs 76–79.

countries, NFPEs have also been required to provide social services. These noncommercial activities may be financed by cross-subsidization between different groups of consumers and/or by incurring losses that are financed from the budget or by borrowing. In some instances, excessive prices may be charged, and the supernormal profits earned transferred to other enterprises or to the budget. This confuses the fiscal and commercial responsibilities of government and makes it difficult to ensure that managers are fully accountable for their performance. In principle, where such activities are desirable, they are best financed by explicit budgetary transfers, for example, through a clear contract for the noncommercial output by the NFPE (the transfer, in other words, reflects the price the government is willing to pay for the noncommercial service). Some countries are moving in this direction.[29] Otherwise, as a minimum standard, it is proposed that QFAs undertaken by NFPEs be clearly identified and reported.

40. To help define responsibilities in this area more clearly, it is proposed that each country identify and report all major noncommercial activities of NFPEs and indicate the policy rationale for their continuation.[30]

41. Serious transparency concerns can also arise over the manner in which NFPEs (and PFIs) are privatized, which can have negative fiscal impacts and erode public support for privatization. Privatization should be conducted with as much openness as permitted by sound marketing considerations. The conduct of individual privatizations should be subject to ex post audit (e.g., by a national audit office), to ensure they are carried out in accordance with the law, that the business was properly valued, and that there was contestability among bidders. Indemnities given to purchasers should be disclosed at the time (and included in the government's general statement of *contingent liabilities*).[31] The International Organization of Supreme Audit Institutions (INTOSAI) has published Draft Guidelines on Best Practice for the Audit of Privatizations.[32]

Legal and Administrative Framework

1.2 There should be a clear legal and administrative framework for fiscal management.

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[29]In **New Zealand**, noncommercial services by NFPEs are contracted for by government agencies and funded from the budget (e.g., the maintenance of the electoral rolls by New Zealand Post Limited). Indeed, any activity that an NFPE is required by government to undertake for social policy purposes has to be the subject of a policy directive tabled in parliament.

[30]Reporting of QFAs is discussed in paragraphs 76–79.

[31]See paragraphs 67–71.

[32]See the INTOSAI (1997).

42. Three principal elements of the legal and administrative framework are essential to support transparency of fiscal management: (1) a comprehensive framework for budgetary and extrabudgetary activities; (2) a legal basis for all taxes; and (3) ethical standards of behavior.

Comprehensive framework for budgetary and extrabudgetary activities

1.2.1 Fiscal management should be governed by comprehensive laws and administrative rules applying to budgetary and extrabudgetary activities. Any commitment or expenditure of government funds should have a legal authority.

43. The effectiveness of the budget depends on the strength of its basis in law and on the supporting regulations and administrative practices. The relative importance of codified budget laws, regulations, and administrative practices varies considerably among countries. Box 4 provides a summary overview of the very different traditions of budgetary law. Despite these differences, there are important elements that should be embedded in all legal/administrative frameworks. Public funds can only be spent by law; the budget should be comprehensive, covering all general government transactions (albeit, possibly through different funds); budget transactions should be shown in gross terms; a minister responsible for government finance should be so designated, and given effective power of budget management, including the authority to sign loan agreements; individual agencies and designated officials of agencies should be held accountable for collection and/or use of resources by these agencies; contingency or reserve provisions should specify clear and stringent conditions for use of such funds; and audited reports showing clearly how public funds have been used should be prepared at least annually for the legislature and the public. These elements are fundamental to transparency. It is recognized, however, that full observance of these elements will depend on capacities of individual countries, but the adoption of a legal framework embodying all of them is seen as appropriate for all countries.

44. The existence of a budget law does not guarantee that its provisions will be observed in practice. There are several areas of budget law that are commonly abused and need special attention if the goals of fiscal transparency are to be fully realized. Among these are excessive use of *supplementary budgets*, abuse of *contingency funds*, and accumulation of *arrears*.[33]

45. Supplementary budgets, which are presented to parliament during a budget year to seek additions or changes in parliamentary authority, are transparent in the sense that they are formally presented to parliament. Often, however, these are not reviewed in the context of their expected aggregate impact on the fiscal outcome. Moreover, in some countries, they are used as devices to authorize spending ex post rather than to seek parliamentary authority prior

[33] Arrears are discussed in paragraphs 128–31.

Box 4. Budget System Law—A Variety of Traditions

European, civil law-based countries, such as **France**, tend to rely more on budget practices and procedures codified at a high-level, consistent with a strong administrative control orientation in these countries. **United Kingdom**-based budget laws have tended to focus on principles of handling public funds, with detailed budget procedures reflected in regulations and administrative instructions. More recently, however, there has been a trend among some of these countries toward developing more comprehensive legislative frameworks that emphasize government responsibility for transparency and accountability. In the **United States**, much of the budget legislation is concerned with setting medium-term budget targets through the congressional budget process, because of the important role the United States Congress plays in shaping and controlling the budget.

Most developing countries have followed either a European- or United Kingdom-based budget legislative model, but in many cases have been unable to develop appropriate legal and administrative systems because of a lack of political and administrative capacity. Economies in transition are in various stages of developing a legislative basis for their budget processes, but many have difficulties in implementing realistic fiscal policies and in controlling budget execution in practice. The work of establishing a sound legal framework in these countries needs to be supported by the capacity to reflect that framework in realistic budgets.

to spending taking place. It is proposed that the treatment of supplementary budgets be made more transparent through their inclusion as part of fiscal reporting and reconciliation.[34]

46. Contingency (or reserve) funds are also a common avenue for abuse of the law and/or lack of transparency. As noted above, a possible weakness in the budget law is that the conditions for use of contingency funds are not clearly specified. In some countries, this weakness is compounded by provisions in the budget law or the annual appropriation law that allow the appropriation of unanticipated financial receipts to meet unspecified contingencies. In addition to ensuring that laws define the conditions under which contingency funds are used, actual practices should be closely monitored as part of fiscal reporting and auditing.[35]

Legal basis for all taxes

1.2.2 Taxes, duties, fees, and charges should have an explicit legal basis. Tax laws and regulations should be easily accessible and understandable, and clear criteria should guide any administrative discretion in their application.

[34]Reporting and reconciliation are discussed in paragraphs 142 and 145.

[35]See paragraphs 140–44 and 149–55.

Explicit legal basis for taxes

47. The constitutional framework of virtually all countries embodies the principle that no tax[36] may be levied except under the authority of a law (although there are some differences in the application of this principle). In particular, subnational governments should not be allowed to levy taxes or fees when they do not have the legal authority to do so. There should also be adequate mechanisms to challenge the legal basis of taxes and fees, and of tax laws and regulations.

Accessibility and understandability

48. Although most countries require the publication of legislation (e.g., in an official gazette), tax laws, regulations, and other documents relating to administrative interpretation of tax law should also be accessible to the general public. Explanatory materials (e.g., instructions and pamphlets), usually prepared by the tax agency, should be kept up-to-date. New budget revenue measures should be given sufficient publicity so that taxpayers understand how they might be affected. Best practice would also involve making available to the public the material the tax agency uses in applying the tax laws (e.g., manuals and legal opinions).

49. In addition to being accessible, the tax laws should be understandable. This involves following the basic rules of legislative drafting, such as good organization, including in the law all elements needed to define tax liability and tax procedure, avoiding of ambiguities and contradictions, and the including of definitions where necessary. Box 5 illustrates the development of a clear and understandable tax law in **Latvia**.

Clear criteria for administrative application

50. A corollary of requiring that taxes be imposed under law is that administrative discretion in applying tax laws must be limited. Case-by-case negotiation of tax liabilities between officials and taxpayers should not be the general rule in any country, both because of the nontransparency of such practices and the potential for corruption. However, appropriate provision should be made for settlement of tax cases, agreement on installment payment schedules, and writing off of uncollectible amounts—all with procedural safeguards. Similarly, the tax laws should clearly establish the powers and limitations of the tax administration to search the premises of taxpayers, demand information from taxpayers and third parties, apply indirect methods to determine income and sales, and enforce the collection of *tax arrears*.

51. Clarity and precision of legislation are emphasized as a means of promoting transparency and fighting corruption with respect to customs in the *Declaration of the World*

[36]The term "tax" in this section is used to refer to any compulsory payment under law, including customs duties.

Box 5. Reform of Tax Legislation in Latvia

Tax reform in **Latvia**, undertaken after the country became independent in 1992, illustrates good practice for transparency of tax policy and legislation both in process and ultimate result. The goal was to adopt a comprehensive new set of laws that would be compatible with the growth of a market economy, and would also facilitate economic relations with the EU.

The process of drafting was conducted openly, and with the object of creating a set of laws that could be understood by all affected parties. Perhaps most important, transparency and ultimate acceptance of the package by the legislature and the private sector was facilitated by taking into account comments from the private sector. The government also introduced accompanying amendments to relevant portions of related laws, such as the Law on Accountancy, the Law on Foreign Investment, and the Law on the State Revenue Service. These amendments were presented as critical portions of the comprehensive policy package. The result was a set of laws that were comprehensible to those affected and worked together efficiently.

Important features of the Latvian tax law framework include the following:

- an overall implementing and administrative law which contains definitions applicable to all the substantive taxes, provisions governing rights and responsibilities of all taxpayers and the tax administration, and a list of the taxes covered;
- a simplified system of depreciation based on pools of a few types of assets;
- accurate measurement of income, with favorable depreciation and carry forward of losses, rather than a complex and distortive system of tax incentives;
- simple rate structures; and
- relatively few exemptions from the value-added tax, with transparent and simple rules to determine the origin of goods and services.

Customs Organization (Customs Cooperation Council), Arusha 1993,[37] which sets out guidelines for a program to achieve integrity in customs administration.

52. Revenue administration should be organized in such a way as to minimize opportunities for collusion between taxpayers and tax officials. In this connection, administrative functions should be distributed across the tax administration, to provide a self-checking element whereby the work of staff engaged in one function serves as a control on the work performed by staff in other functions.

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[37]This can be accessed through the Transparency International web site (http://www.transparency.de/sourcebook/).

53. Internal audit systems should be established to ensure the financial accountability of tax collection staff and systems, and adherence to tax administration policies and procedures in their dealings with taxpayers.

54. Information technology can also play an important role in eliminating opportunities for discretionary action as well as providing for effective monitoring of arrears, exemptions, appeals, and payments. The computer systems should be designed to provide a full "audit trail" on the information recorded in the taxpayers' accounts by cross-referencing this information to original source documents and to the names of the staff who entered it into the system. Box 6 illustrates recent improvements introduced in the Customs Service of the **Philippines**.

Box 6. Computerization and Improved Customs Transparency in the Philippines

In the past five years, the Philippine Customs Service has invested heavily in information technology as one means of addressing its significant administrative problems. All major import-clearance functions have been automated and the benefits are considerable:

- an electronic "cashless" system now automatically links payments made through the banks to the customs clearance documents, solving many problems (e.g., the diversion of duty and tax payments made through the banking system, and customs cashiers disappearing with the day's receipts). This new system ensures that payments collected by the banks are credited in a timely manner to the government account;
- the electronic filing of documents eliminating of the need for face-to-face contact between importers' agents and customs officers has replaced the paper-based system that required over 90 steps and 40 signatures;
- a computerized system is now used to select goods for inspection, reducing physical inspections by 100 percent to approximately 15 percent and releasing goods not subject to inspection in hours rather than days;
- electronic messages notifying warehouse operators that the customs clearance process has been completed and that the goods can be released has improved the security of goods under customs control.

In the Philippine Customs Service, there is now rigorous standardization: transactions that do not meet the requirements are simply rejected by the automated system. The ability of individual customs officers to exercise discretion has largely been eliminated.

55. Computer systems should also have the capacity to readily exchange information among revenue departments. In addition to taxes collected by the tax and customs departments, taxes collected under the social security system (if not collected by the tax department) should be accounted for in a clear manner, and audit information should be shared with tax departments. This arrangement would be facilitated by the use of a common taxpayer identification number (TIN) by all revenue departments.

56. As in other areas of administration, earmarking, and netting operations, to the extent they are used, should be clearly shown and accounted for. If, for instance, a tax department is authorized to use a share of the revenue it collects from audits for staff bonuses or certain administrative expenditures, then the rules on the use of these funds should be clearly specified and normal accounting regulations should apply.

Taxpayer rights and openness of administrative decisions to independent review

57. An equally important aspect of transparency in tax and customs legislation and its administration is the system's openness to review of administrative decisions and the extent to which government is obliged to make taxpayers aware of their rights. Taxpayers' rights should be clearly stated and include the following: access to timely, accurate information; fair and expeditious treatment; confidentiality in interactions with the authorities; a reasonable penalty structure; and advance written rulings. Taxpayers should have access to a well-functioning system of administrative review of decisions, as well as the opportunity to appeal to an independent judiciary. In most countries, these rights exist on paper; however, they often function imperfectly. In particular, the appeals system may fail to provide safeguards against arbitrary administrative action and keep the tax administration within the bounds of the law. A number of countries have a taxpayer bill of rights or the equivalent.[38]

Ethical standards of behavior

1.2.3 Ethical standards of behavior for public servants should be clear and well-publicized.

58. An important underlying element of fiscal accountability is that officials handling or making decisions about the receipt or use of public moneys, or exercising their official powers, should be subject to a code of conduct that precludes unethical behavior. Some aspects of such a code could be included in the budget and tax legislation; other aspects may need separate legislation or regulations. The United Nations' International Code of Conduct for Public Officials, which is summarized in Box 7, provides a basis for implementing a standard of ethics and for strengthening an existing standard.[39] Administrative support is necessary for effective implementation, and recent experience with addressing problems of corruption in the public service in the **Republic of South Africa** may be helpful in this respect.[40]

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[38]For the **United States**, see (http://www.irs.gov/prod/ind_info/advocate.html).

[39]See UN (1996). The Council of the OECD also recently adopted a set of principles for ethical conduct in the public service based on the UN Code and other efforts to promote ethical behavior (http://193.51.65.78/puma/gvrnance/ethics/pubs/rec98/rec98e.htm).

[40]See van der Westhuizen (1998).

Box 7. Code of Conduct for Public Officials

The International Code of Conduct for Public Officials, adopted by the United Nations on December 12, 1996, contains the following provisions:

- a public office is a position of trust, implying a duty to act in the public interest;
- public officials shall avoid conflicts of interest;
- public officials shall comply with any applicable requirements to disclose their personal assets and liabilities;
- public officials shall not solicit or accept any gift or favor that may influence the performance of their duties;
- public officials shall respect the confidentiality of any information in their possession;
- public officials shall not engage in political activity outside the scope of their office such that it impairs public confidence in the impartial performance of their duties.

II. PUBLIC AVAILABILITY OF INFORMATION

59. A fundamental requirement of fiscal transparency is that comprehensive fiscal information be made available to the public. Principles and practices in this regard relate to the type of fiscal information that should be provided and to an explicit public commitment to the timely publication of such information. Requirements in this area go beyond the production of high-quality fiscal data; government efforts should include the wide dissemination of comprehensive fiscal information through publications and public broadcasts.

Comprehensive Information on Fiscal Activity

2.1 The public should be provided with full information on the past, current, and projected fiscal activity of government.

60. The Code proposes good practices concerning the provision of fiscal information in four areas: (1) coverage of the annual budget; (2) outturns and forecasts; (3) contingent liabilities, tax expenditures, QFAs; and (4) debt and financial assets. The coverage of the annual budget is also dealt with in Section III of the Manual, which focuses on budgetary practices.

Coverage of the annual budget

2.1.1 The annual budget should cover all central government operations in detail and should also provide information on central government extrabudgetary operations. In addition, sufficient information should be provided on the revenue and expenditure of lower levels of government to allow a consolidated financial position for the general government to be presented.

Central government budget and extrabudgetary funds

61. The central government budget will usually be the prime focus for fiscal policy analysis. The ex ante fiscal plan presented in the budget should be consistent with ex post accounting reports, and both should cover the finances of all central government EBFs (such as social security funds, commodity stabilization funds, and road funds). Where central government agencies are allowed to finance part of their activities from fees and charges collected by the agency, this should also be shown clearly in the budget and accounting reports of government. These requirements are proposed as a minimum standard.

Consolidated position of general government

62. Although the Code is aimed at the operations of general government, it is recognized that there are often problems in obtaining complete and current data for subnational governments. In many countries, central government is typically the focus of reporting and policy attention. Where subnational governments are traditionally or de facto independent, or

there are timing or other practical limitations, it may not be feasible (or, in some cases, necessary) to present a consolidated budget for general government.

63. The judgement as to whether reporting for only central government is sufficient to meet transparency requirements is a difficult one. Reporting only by central government would be sufficient either where subnational governments are sufficiently well established as fiscal entities for the Code to be applicable separately at that level, or where independent borrowing by subnational governments is effectively controlled by regulation. Ter-Minassian and Craig (1997) observe that "central government controls over subnational governments' borrowing tend to be looser, on the one hand, in countries with poor overall financial discipline and as yet unaddressed fiscal and macroeconomic disequilibria, and, on the other, in countries with well-developed and relatively transparent financial systems, which can rely more on the market to discipline the borrowing of subnational governments."

64. The **United States** provides a good example of reliance on market forces (and voluntary self-regulation) for discipline of subnational governments. It compiles consolidated budget data ex post but the focus of national fiscal policy is on the federal budget because of the degree of independence of state governments. In **Australia** also, states are independent sovereign entities and present their budgets independently and at different times from the central government. However, there has been a considerable effort to standardize statistical presentation in line with international standards for all jurisdictions, and the focus of fiscal policy in the future will be explicitly directed at general government.

65. Although presentation of a general government budget may not be feasible for many countries, all governments should provide ex post data on general government. This can be done through national accounts-based reports, provided these are based on actual budget outturns for the various components of general government. In the case of subnational governments, the compilation need not be based on the actual outturns of all individual governments: it can be based on a sample survey that covers the actual budget outturns for a significant portion of total transactions for lower levels of government. Best practice would be that information on the expected general government budget outturn for the previous year be included in the central government budget documentation. Where the distribution of taxes, expenditure allocations, or the control of subnational borrowing are of fiscal policy significance, uniformly classified estimates of general government budget revenue, expenditure, and borrowing should be provided at the time the central government budget is presented.

Outturns and forecasts

2.1.2 Information comparable to that in the annual budget should be provided for the outturns of the two preceding fiscal years, together with forecasts of key budget aggregates for the two years following the budget.

66. For a more complete picture of the current fiscal position, information on past fiscal performance should be presented with the annual budget. Summary budget tables should present the original budget aggregates for the two years prior to the budget year, together with the actual outturn (or expected outturn, if the final outturn is not yet available). This allows an assessment to be made of recent performance compared to budget, and may draw attention to significant forecasting or policy risks, and, more generally, to the realism of the budget being presented. Any changes to the presentation or classification of items in the budget statements from year to year should be disclosed, together with the reasons for the changes and their approximate fiscal consequences. Budget documents should also include forecasts of key budget aggregates for the two years following the budget.[41]

Contingent liabilities, tax expenditures, and quasi-fiscal activities

2.1.3 Statements should be published with the annual budget giving a description of the nature and fiscal significance of contingent liabilities, tax expenditures, and quasi-fiscal activities.

Contingent liabilities

67. Contingent liabilities reflect existing *commitments*, the ultimate fiscal consequences of which (including the possibility of no consequence) are dependent on future events that may or may not materialize. Examples include loan guarantees, exchange rate guarantees, deposit insurance, and indemnities (covering, for instance, commitments by government to private companies in the context of privately financed infrastructure projects or recently privatized enterprises).[42] Future obligations under public pension programs are not contingent liabilities.[43] Implicit guarantees, such as the possibility that a government may in the future bail out a public enterprise or a private sector bank, are also excluded, because of the potential *moral hazard* to which being transparent about such provisions could give rise.

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[41]Medium-term fiscal forecasts are discussed in more detail in paragraphs 98–101.

[42]See Perry, Irwin, Klein, and Thobani (1997) for a detailed discussion of the issues in dealing with public risk in private infrastructure projects.

[43]These are considered in paragraphs 102–103 in relation to reporting on the sustainability of fiscal policy. Although future social security obligations are often described as contingent liabilities, and the strength of the obligation varies among countries, the obligation does not meet the accounting recognition criteria for a liability (see IFAC (1998); paragraphs 707 and 720; and paragraphs 692–701 for a discussion of contingencies). Only amounts due and payable are recognized as a liability. Moreover, although payment of a pension to an individual pensioner (or unemployment insurance to an individual unemployed person) is contingent on that person meeting the eligibility criteria, aggregate future pension (and other social insurance) obligations of the government are not contingent (although there is uncertainty about their precise magnitude).

68. Contingent liabilities can be quite large, and all countries should take measures to ensure that they are reflected in fiscal decision making. However, these liabilities are typically only covered in cash-based financial reporting if and when the covered event occurs, and a financial obligation must first be met. For example, the provision of a loan by government will be recorded as expenditure under *cash basis* accounting at the time the loan is disbursed, and should also be recorded in the government's statement of financial assets. If, instead, the government guarantees a loan by a third party, the accounting treatment is quite different: the guarantee will appear in the government's accounts only if and when the government is required to honor the guarantee.[44] Transparency requires that such contingent liabilities should be shown, to give a full picture of fiscal activities and policies. Reporting of contingent liabilities will assist governments in managing fiscal risk. It may also help focus attention at the outset on the design of policies that involve risk-sharing between the government and the private sector.

69. If no reporting is required for such liabilities, there may be an incentive to substitute guarantee or other off-budget instruments for budget measures, and the relative merits of budgetary and other instruments are unlikely to be properly evaluated.[45] Lack of such reporting will also likely result in a failure to properly assess the sustainability of the fiscal position. A buildup of unreported liabilities of this nature can give rise to large (actual or potential) fiscal shocks that greatly complicate the task of fiscal management. The fiscal cost of banking sector reconstruction in some countries has dramatically demonstrated the potential magnitude of the problem.

70. It is therefore proposed as a minimum standard that all countries publish a statement of the outstanding stock of contingent liabilities of the central government. These contingent liabilities may be reported in budget documents as part of a broader fiscal risk statement.[46] The statement should include a brief indication of the nature of each contingent liability, to enable at least some assessment of its potential fiscal significance. For example, reporting of a loan guarantee should include the amount and duration of the loan in question; reporting of an indemnity should include the terms, amount, and duration of the indemnity.

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[44]See IFAC (1998), paragraphs 692–701, for a discussion of the treatment of contingencies under accrual accounting.

[45]To address this problem, the **United States** passed the Federal Credit Reform Act of 1990. Government agencies are now required to estimate the expected cost of loan guarantees, and to budget for them by including the full expected cost as expenditure in the year in which the obligation is entered into.

[46]Reporting on contingent liabilities and fiscal risks (see paragraph 107) will require development of an underlying organizational structure and system for recording, reporting, and analyzing activities that give rise to these risks. This Manual recommends only that governments make a commitment to report on these elements to the public; it does not attempt to define precise mechanisms for developing such systems.

71. Best practice would be to include an estimate of the expected cost of each contingent liability—to the extent it is technically possible to do so—and to provide information on the basis on which the estimate has been made. In addition to the outstanding value of the stock of contingent liabilities, transparency would also be served by providing a schedule of when contingent liabilities are due to mature and by listing those contingent liabilities reported with the previous year's budget that were recognized as expenditure during the preceding year.

Tax expenditures

72. Tax expenditures include exemptions from the tax base, allowances deducted from gross income, tax credits deducted from tax liability, tax rate reductions, and tax deferrals (such as accelerated depreciation). They are often identical in their effects to explicit expenditure programs. For example, assistance to industry can be delivered either through appropriated expenditure programs or through concessional tax treatment.

73. Tax expenditures do not require formal annual approval by the legislature and, once introduced, are typically not subject to the same degree of scrutiny as actual expenditures. In addition, in some countries, they may be granted under ministerial discretion. These practices can lead to an undesirable proliferation of tax expenditures, lack of review of effects and continued appropriateness, serious deficiencies in the tax base, and lack of transparency over their fiscal cost and distributional effects. Tax expenditures often favor well-organized interest groups.

74. It is therefore proposed, also as a minimum standard, that a statement be published with the annual budget of all tax expenditures, together with a brief explanation of the nature of each program, to enable at least some assessment of their justification and fiscal significance. This will require decisions over a number of elements, including the precise definition of a tax expenditure,[47] and the coverage of the report in terms of types of taxes and levels of government at which they are imposed. Practices in this regard vary widely among the countries currently reporting tax expenditure information.[48] From the point of view of transparency, however, it is important that all countries provide information about the basis on which reports have been prepared.

75. Best practice is to report an estimate of the approximate fiscal cost of each tax expenditure. Although there can be serious difficulties in cost estimation, reporting the approximate cost and making the basis of the estimates available for independent scrutiny can significantly enhance the transparency of fiscal management. A number of OECD member

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[47]The definition of tax expenditures is particularly complex, requiring the definition of a "benchmark" or "normal" tax structure, departures from which are considered to be expenditures.

[48]See OECD (1996).

countries regularly publish an estimate of tax expenditures. Box 8 provides information on selected country practices.

Box 8. Tax Expenditure Reporting

Germany and the **United States** were the first countries to report tax expenditure information, in the late 1960s. Tax expenditure reports are now a legal requirement in eight countries (**Australia, Austria, Belgium, France,** Germany, **Portugal, Spain**, and the United States). Most of the countries reporting information do so annually; in Australia, Belgium, **Finland,** France, Portugal, and Spain, the tax expenditure report is linked explicitly to the budget process.

In Germany, tax expenditures are reported as part of a "subsidy report," which includes all forms of federal support through both direct expenditures and tax expenditures. (Most states provide similar subsidy reports to state legislatures.) The foregone revenues are reported for two prior years, the current year, and the following year. The federal subsidy report lists for each tax expenditure item the revenues foregone to the federal budget and to all the territorial authorities. The report covers a wide range of direct and indirect taxes, and classifies them by industrial sector and within sectors by type of tax. In addition to regular biennial reports, more detailed reports are prepared on individual sectors, and supplementary calculations are made if changes to the law are planned. To prevent certain types of tax expenditure from becoming permanent parts of the tax system, they may be designed to phase out over time (e.g., the tax incentives for investment in eastern Germany). The subsidy reports are submitted to the federal legislature, where they are considered by various committees. The reports are subjected to scrutiny by the Federal Court of Audit. Independent economic research institutes conduct their own analyses of the economic effects and efficiency of subsidies, and make their own calculations of the magnitude of tax expenditures (and subsidies more generally) based on broader definitions.

Quasi-fiscal activities

76. QFAs may be conducted by the central bank, PFIs, and NFPEs.[49] Box 9 presents a more complete listing of the different types of QFAs. QFAs raise a number of complex issues. For example, with respect to central bank QFAs, only where the financial effects are fully reflected in the profit and loss account in the financial year in which they occur will such QFAs be reflected in the government's budget, through a change in the amount of profit transferred to central government budget revenue.[50] This has a number of consequences from a transparency standpoint:

- even if all QFAs impact immediately on the profit and loss account of the central bank, and there is a 100 percent rate of transfer of profits to the central government, these

[49]As discussed in paragraphs 34–41.

[50]In some instances, revenues earned by a central bank from a QFA may be transferred directly to the budget (e.g., revenues earned from the operation of a multiple exchange rate system). In this case, central government tax revenue would be understated, and nontax revenue overstated, although the net fiscal effect would be fully captured.

Box 9. Types of Quasi-Fiscal Activity

Operations related to the financial system
Subsidized lending
- Administered lending rates
- Preferential rediscounting practices
- Poorly secured and sub-par loans
- Loan guarantees

Underremunerated reserve requirements
Credit ceilings
Rescue operations

Operations related to the exchange system
Multiple exchange rates
Import deposits
Deposits on foreign asset purchases
Exchange rate guarantees
Subsidized exchange risk insurance

Operations related to the commercial enterprise sector
Charging less than commercial prices
Provision of noncommercial services (e.g., social services)
Pricing policy for budget revenue purposes
Paying above commercial prices to suppliers

fiscal activities are effectively being reported on a net basis,[51] and there is insufficient information on the underlying gross flows;

- the rate of profit transfer is typically less than 100 percent, with some portion of central bank profits being retained as central bank reserves.[52] The cost of QFAs in these circumstances is therefore met in part by the central government budget and in part by a smaller increase in central bank reserves than would have occurred in the absence of the QFAs;

[51]An additional factor is that there will typically be a time lag between the period in which the QFA occurs and impacts on the central bank's profit and loss account, and the period in which the central bank's surplus is transferred to the central government.

[52]In some cases, the central bank law may provide that all profits be transferred to the central government once reserves reach a certain level. More generally, the marginal rate of transfer may vary over time.

- in some cases, the central bank engages in such extensive QFAs that it makes a loss.[53] Central bank losses are not reported as expenditure of the central government but their fiscal impact needs to be taken into account; and

- the effects of some QFAs are not reflected immediately in the central bank's profit and loss account. For example, central bank loans to a particular private sector entity may be reflected in an overvaluation of the central bank's assets rather than a reduction in operational surplus that reflects the implicit subsidy.[54] And contingent liabilities entered into by the central bank—such as exchange rate guarantees, which can be of significant size—are not recorded as expenditure until the contingency arises and the liability must be met.

77. Some of these considerations apply also to the transparency of QFAs conducted by PFIs and NFPEs. The Code therefore calls for presentation with the annual budget of a comprehensive statement of the nature and fiscal significance of QFAs conducted by the central bank and other nongovernment agencies so that they are open to debate and can be taken into consideration in assessing the fiscal position. This is again proposed as a minimum standard. The statement should be compiled by the central budget ministry, on the basis of information provided by the central bank and nongovernment agencies undertaking QFAs. It should include sufficient information to enable at least some assessment of the potential fiscal significance of each QFA. For example, reporting of a guaranteed loan should at least include the amount and duration of the loan; reporting of a subsidized loan should include at least the amount and duration of the loan and the rate of interest; and reporting of a consumer subsidy by an NFPE should include at least some indication of the divergence between the price charged and a price based on full cost recovery. In addition, the central government should report on its policy with respect to the split of central bank profits between central bank reserves and the central government budget, and note any changes in policy or practices. Similarly, the central government should report the transfer or dividend policies, and any changes in them, applying to PFIs and NFPEs.

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[53]Significant central bank losses are not uncommon in developing countries; in some instances annual losses have exceeded 5 percent of GDP (see Robinson and Stella, 1993). There is no reason why a central bank cannot go on making losses year after year without any funding from the central government, because of its ability to generate seignorage revenues.

[54]Such subsidized credit needs to be distinguished from rediscounting by central banks. The latter activity is monetary in character and should generally be regarded as involving an exchange of assets of equal value. Rediscounting is provided to solvent institutions on a fully collateralized basis, often at market or penal rates of interest. Where rediscounting is provided at below market interest rates, however, the interest rate subsidy should be regarded as a QFA. Similarly, the practice of unremunerated (or underremunerated) reserve requirements can impose a significant tax on financial institutions where interest rates are high. In such situations, unremunerated reserve requirements should be regarded as a QFA.

78. Best practice in the reporting of QFAs would include two further elements.[55] First, it is highly desirable that some quantification of the likely magnitude of the individual activities be reported. Although this is not always feasible,[56] it is in general possible to provide an indication of the order of magnitude of fiscal effects (see Box 10).[57] For example, reporting of an exchange rate guarantee issued by the central bank should include the value of guarantees outstanding and the cost if they were called at the current exchange rate. Second, some indication of the basis of calculation used to estimate the fiscal cost should also be provided. Estimation of the fiscal effects of QFAs conducted by the central bank (or public enterprises) might be the joint responsibility of the central bank (or public enterprise concerned) and the central budget ministry, with the latter combining all central bank and public enterprise QFAs to produce an overall report of quasi-fiscal activity across the public sector. Where QFAs are extensive and quantifiable, there may be merit in reporting them together with the government's overall fiscal balance in an "augmented fiscal balance."[58]

79. **Argentina's** budget law requires reporting on the consolidated budget sector. An episode of banking sector restructuring in Argentina in 1994–95, during which time the central bank provided long-term loans to private banks, was therefore reported as a QFA and included in central government expenditure. Similarly, the cost of issuing government bonds to financially troubled banks in **Mauritania** in 1986 was recorded as central government subsidized expenditure.[59]

Debt and financial assets

2.1.4 The central government should regularly publish information on the level and composition of its debt and financial assets.

80. The Code calls for the regular publication of information on the level and composition of central government debt and financial asset holdings, which will yield a measure of net

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[55]As noted in paragraph 39, best practice in the management (as opposed to the reporting) of QFAs is to finance them through an explicit budget subsidy, in effect eliminating the QFAs by incorporating them in the budget.

[56]For example, it can be extremely difficult to estimate the effects of ceilings on credit, because of the difficulty of assessing the counterfactual: how much more demand for credit would there have been beyond the ceiling (assuming there is demand up to the level of the ceiling)?

[57]See Mackenzie and Stella (1996) for a detailed discussion of issues in estimating and reporting the size of QFAs.

[58]See Box 15 for discussion of this issue.

[59]See Daniel, Davis, and Wolfe (1997).

Box 10. Estimating the Fiscal Effects of QFAs

Estimating the fiscal effects of some QFAs is relatively straightforward: the necessary information is contained in the accounting records of the enterprise or central bank (e.g., the cost to an NFPE of providing social services, where the cost is separately recorded). Others, however, are more difficult to quantify (e.g., the cost of a loan guarantee). Worked examples are provided below to illustrate quantification of QFAs in two relatively straightforward cases.

Example 1: A subsidized loan provided by a PFI
A state-owned bank provides a loan of $10 million to an NFPE at a 5 percent rate of interest. Commercial rates of interest for comparable loans range from 15 percent to 20 percent, depending on specific elements bearing on credit risk. The annual subsidy should be estimated as between $1 million and 1.5 million. In the absence of any relevant factors indicating an alternative treatment, the cost of the QFA should be reported as the midpoint of the range, or $1.25 million.

Example 2: A multiple exchange rate
The central bank operates a special appreciated exchange rate of 2.75 local currency units (LCU) to the dollar for mineral exports, and of LCU2 for imports of a staple foodstuff. The central exchange rate is LCU3 to the dollar, entailing a tax on mineral exports and a subsidy on imports of the staple food. If total mineral exports are $3 billion, and total imports of the food item are $300 million, the effects of the QFA can be estimated and reported as follows:

Quasi-fiscal tax on mineral exports: (3-2.75)LCU/$ x ($3,000,000,000) = LCU750,000,000
Quasi-fiscal subsidy to imports: (3-2)LCU/$ x ($300,000,000) = LCU300,000,000

In this example, the central bank gains a net LCU450,000,000.

debt. With these figures, a government can better assess its ability to finance its activities and honor its debt obligations, and estimate the amount of future revenues required to meet all existing commitments. It is most important to monitor the changes in the level and composition of public debt and financial assets, since these are the basis for accepted approaches to assessing the sustainability of fiscal policy. Best practice would involve reporting on physical asset holdings. Though this practice would introduce a variety of new accounting issues, including the valuation of nonfinancial assets of government, it would provide information to help assess government's performance in the stewardship and utilization of nonfinancial assets, and provide an indication of future maintenance and replacement requirements. It would also facilitate the derivation of a complete *government balance sheet*, which would allow information on net worth and government solvency to be incorporated into sustainability assessments.[60]

[60] A discussion of fiscal sustainability appears in paragraphs 102–103.

Reporting of debt

81. Reporting should cover the comprehensive debt of central government, including securities, loans, and deposits.[61] The level of debt at the reporting date and the previous reporting date (for comparison purposes), should be disclosed. Valuation methods and practices (e.g., revaluation of indexed debt),[62] together with any special characteristics of debt instruments or any liabilities not reported, should be noted as memorandum items. Classification and definition of debt should be in accordance with internationally recognized practices (e.g., as in the GFS Manual or OECD, 1988).

82. Debt should be broken down by remaining maturity, and classified as short (less than 12 months), medium or long term.[63] Breakdowns of debt should also be provided, where relevant, by domestic and foreign components according to residence, by currency of issue (including indexing), by debt holder, and/or by debt instrument. Any debt arrears should be disclosed, with arrears on interest and principal identified separately. In addition, any debt swaps should be disclosed. As a minimum standard, reporting of central government debt should be done at least annually, within one to two quarters of the end of the reference period, but debt of major policy significance should be reported quarterly. Debt (and financial assets) should be reported in the annual central government budget, and in the final accounts.

83. Best practice, as reflected in the IMF's Special Data Dissemination Standard (SDDS),[64] would involve reporting at least on a quarterly basis, within one quarter of the end of the reference quarter. It would also involve reporting debt service projections, including projected interest and amortization payments on medium- and long-term debt. This information should be provided quarterly for the coming four quarters and annually thereafter. Projected repayments of short-term debt should be reported on a quarterly basis.

Reporting of financial assets

84. Reporting of financial assets should cover all such assets of central government as at the reporting date as well as those as at the previous reporting date. The report should include

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[61]The reporting standards for debt set out here are based on those in the IMF's General Data Dissemination System (GDDS) (IMF, 1998b). For a discussion of issues in the reporting of government debt and financial assets, see IFAC (1998). Reporting of government guaranteed debt is covered in paragraphs 67–71.

[62]Indexed debt is that denominated in domestic currency but with its nominal value indexed to a foreign currency, inflation, or a commodity (such as oil or gold).

[63]Where remaining maturity is not available, original maturity may be reported.

[64]See IMF (1996a). As of June 1998, 46 countries had subscribed to the SDDS.

a clear statement of the accounting policies that have been followed with respect to asset valuation.

85. Financial assets are defined as nonfinancial assets available to the government to settle liabilities or commitments, or to finance future activities. Financial assets to be reported include cash and cash equivalents;[65] other monetary assets, such as gold and investments; and loans and advances. In addition to reporting financial assets according to these categories, additional breakdowns should be provided within each category. For example, investments might be broken down into direct marketable securities, equity investments in private companies, portfolio investments in private companies, and investments in international institutions. Loans and advances receivable might be broken down by sector (e.g., agricultural loans, student loans, and housing loans), and within sectors by major loan programs.

86. Foreign exchange reserves held by the central bank should not be reported as part of the central government statement of financial assets for fiscal policy purposes. They are generally held for the purpose of possible exchange market intervention, although it is acknowledged that in some countries central bank reserves have been run down as a matter of central government policy for other purposes, including debt repayment, even when held by an independent central bank. Foreign reserves should, however, be reported as part of monetary and foreign exchange transparency requirements—generally by the central bank.

87. Any special characteristics of financial assets, such as being secured against a debt or other specific liability, or any restrictions on the use of an asset or the income deriving from it, should be noted as memorandum items. Any financial assets excluded from reporting should also be noted. Reporting of financial assets should be at the same intervals as for reporting debt.[66]

Commitment and Timing of Publication

2.2 A public commitment should be made to the timely publication of fiscal information.

88. The Code proposes good practices dealing with: (1) commitments to publication; and (2) the timing of publication.

Commitments to publication

2.2.1 Specific commitments should be made to the publication of fiscal information (e.g., in a budget law).

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[65]Cash and cash equivalents cover cash on hand, demand deposits, and short-term highly liquid investments readily convertible to cash.

[66]As outlined in paragraph 82 above.

89. The use of discretion in deciding whether, when, in what detail, and to whom to release fiscal information can damage a government's credibility. It will often be tempting for governments to be more forthcoming with favorable than with unfavorable information. A long period of inconsistent observance of a policy of full and timely disclosure can result in a high level of uncertainty about the true fiscal position.

90. To build credibility, it is proposed that governments commit themselves to the regular publication of fiscal information. This commitment could be in the form of a published statement of practices that the government announces it will follow. Alternatively, such a commitment could be embodied in legislation or regulations, or could refer to international standards. Some such commitment is a minimum standard.

91. Examples of national legislation setting clear requirements for fiscal reporting are discussed in Box 11. In addition, many countries have committed themselves to the standards for publication of fiscal and other macroeconomic data contained in SDDS. In the fiscal area, these include commitments to the timeliness and periodicity of reporting on general government operations, central government operations, and central government debt. Only a few countries currently exhibit good practice in fiscal reporting in terms of the SDDS, but many others are moving to improve their reporting practices to comply with it.

92. A further element of best practice in this area is freedom of information legislation. A number of governments have legislative requirements that government agencies make available to the public on request any information they hold, subject to certain clearly specified exceptions (which generally include national security, foreign relations, national economic interest, obligations of confidentiality to a third party, law enforcement, and personal privacy). In some countries, the legislation creates a presumption in favor of public release and places the onus on government to demonstrate an overriding public interest in nondisclosure. The country with the longest tradition of such a commitment to open government is **Sweden**, where the principle has been enshrined in the Constitution since 1776. Members of the public in Sweden (and in a number of other countries) have the right to appeal to the Ombudsman—an office independent of the executive that receives and investigates complaints of maladministration—any government agency's decision to withhold information. In other countries, such as the **United States**, persons have the right to appeal to a court.

The timing of publication

2.2.2 Advance release date calendars for fiscal reporting to the public should be announced.

93. As provided for in the IMF's GDDS, calendars should be released for the year ahead that show no-later-than targets for the release of annual fiscal reports, and a range of dates for

Box 11. Budget Law and Fiscal Transparency

New Zealand's Fiscal Responsibility Act (FRA) of 1994 is a benchmark piece of legislation, which sets legal standards for transparency of fiscal policy and reporting, and holds the government formally responsible to the public for their fiscal performance. Similar legislation, the Charter of Budget Honesty (CBH), has recently been enacted in **Australia**; and **the United Kingdom** has tabled legislation for a Code for Fiscal Stability (CFS). Standards of fiscal transparency under such national legislation are generally more demanding than those suggested under the Code. Many aspects, however, could be emulated by other committed governments.

The FRA principles and standards
The FRA sets out five principles of responsible fiscal management: reducing public debt to prudent levels; requiring an operating balance to be maintained on average over a reasonable time; maintaining a buffer level of public net worth; managing fiscal risks; and maintaining predictable and stable tax rates. The government is permitted to depart from these principles temporarily, provided such departure is clearly justified and a clear plan and time to return to the principles is given.

The FRA then specifies clearly how the government is to report on proposed policies and actual achievements to assure the legislature and the public that the fiscal management principles are being followed. The FRA requires governments to:

- publish a "Budget Policy Statement," containing strategic priorities for the upcoming budget, short-term fiscal intentions, and long-term fiscal objectives, no later than March 31 for a July 1 fiscal year;
- disclose the impact of fiscal decisions over a three-year forecasting period in regular "economic and fiscal updates";
- present all financial information according to generally accepted accounting practices;
- refer all reports required under the Act to a parliamentary select committee.

Some of the specific fiscal reporting requirements included in the FRA are: a preelection economic and fiscal update to be published between 42 and 14 days before any general election; projections of fiscal trends over a ten-year period, at least; and statements of the government's commitments and specific fiscal risks, including any contingent liabilities. *(See http://www.treasury.govt.nz/pubs/bmb/fra/details.htm.)*

Similar legislation
Australia's CBH is similar in principle. Partly because of its federal structure, it gives some emphasis to the role of the Australian Bureau of Statistics to set fiscal reporting standards for all levels of government. It also specifically requires an intergenerational report every five years and a report on tax expenditures—not required under the FRA. Some of these elements, such as tax expenditure reporting, consolidate and extend existing administrative practice, others are new requirements.

The United Kingdom, recognizing the need to go beyond statements of policy that are likely to change when governments change, has presented a bill to parliament based on similar principles to those of the FRA.

more frequently released reports.[67] For example, for a quarterly fiscal outturn report, notice should be given that it will be released between, say, the fifteenth and eighteenth of the

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[67]Release calendars could include a statement that the dates are "expected" or "target," but any subsequent delays due to unforeseen events should be announced as soon as they are evident.

relevant month. Countries should also make widely known the name and address of an office or person that can provide the latest information about the likely release date. The authorities should make a commitment that fiscal reports and data will be released simultaneously to all interested parties.

94. Best practice would be represented by the more demanding standards included in the SDDS.[68] For example, where the release calendar specifies a no-later-than date or a range of dates, the country would announce, by the close of business the prior week, the precise date of release during the following week. Countries would also be encouraged to specify the exact time of release in the calendars.

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[68]For further discussion of advance release date calendars, see IMF (1996a) and IMF (1998b).

III. Open Budget Preparation, Execution, and Reporting

95. Appropriate standards for fiscal data and information make a crucial contribution to fiscal transparency. Principles and practices in this regard relate to the contents of budget documentation, the classification and presentation of budget estimates, budget implementation and monitoring, and fiscal reporting.

Budget Documentation

3.1 Budget documentation should specify fiscal policy objectives, the macroeconomic framework, the policy basis for the budget, and identifiable major fiscal risks.

96. The Code proposes good practices in connection with budget documentation relating to: (1) fiscal policy objectives and sustainability; (2) fiscal rules; (3) the macroeconomic framework; (4) separating existing commitments from new policies; and (5) major fiscal risks.

Fiscal policy objectives and sustainability

3.1.1 A statement of fiscal policy objectives and an assessment of sustainable fiscal policy should provide the framework for the annual budget.

97. In nearly all countries, the budget has an annual perspective; however, it is necessary to make a clear statement about the fiscal intentions of the government, the implications of current policies, and the sustainability of the fiscal position over the medium to long term. It is proposed, as a minimum standard, that all countries present with the budget a fiscal and economic outlook paper. This paper should include a statement of government fiscal policy objectives and priorities, a broad outline of the expected economic outlook, and at least a qualitative assessment of the sustainability of fiscal policies. Most countries should also be able to forecast fiscal aggregates for at least two years beyond the budget year.

Medium-term forecasts and budget frameworks

98. Many countries already present basic fiscal and economic policy statements, and an increasing number are doing so in terms of medium-term fiscal and economic forecasts. As regards the medium-term framework, a distinction needs to be drawn between policy statements based on medium-term forecasts of fiscal aggregates and integrated, consistent, medium-term estimates broken down by individual spending agencies. The latter is sometimes referred to as a *medium-term budget framework* (MTBF). The former represents a necessary step toward an MTBF. Box 12 describes MTBFs in more detail. They are administratively and politically demanding, and therefore confined mainly to OECD countries.

99. An important advantage of medium-term forecasting for developing countries and countries in transition is that it helps link the investment and recurrent budgets. Without this

Box 12. Medium-Term Budget Frameworks: Some Lessons from the Experience of Selected OECD Countries

An MTBF, if applied rigorously, provides a very clear statement of the cost of maintaining current government policies and a mechanism for controlling introduction of new policies and tracking budget implementation beyond a single year. It provides a transparent basis for accountability of the executive branch, and a necessary foundation for more detailed results-oriented budgeting. MTBFs have been used successfully by **Germany**, the **United Kingdom**, and **Australia**. Experience in these and other countries, however, suggests that stringent conditions have to be fulfilled before the full benefits can be attained.

What is an MTBF?
The key characteristics of a medium-term framework are as follows:

- A statement of fiscal policy objectives.
- Integrated medium-term macroeconomic and fiscal forecasts.
- Estimates of expenditure of spending ministries and agencies for two to four years beyond the budget year.
- Formal "forward" or "out-year" estimates —the first out-year estimate of expenditure becomes the basis of budget negotiations for the following year.
- Ministries' and agencies' budget appropriations become hard budget constraints.

The forward estimates process has significant technical advantages both for central agencies and individual spending agencies. For the latter, funding for their programs is given a greater degree of predictability, and the requirement for agencies to maintain multiyear estimates also provides greater clarity of policy at a program level. It should also be noted that, particularly in the United Kingdom and Australia, the establishment of a strong forward-estimates process has been associated with much greater flexibility for agencies in resource use within the aggregate and program ceilings.

Some lessons drawn from experience
The experiences of the three above-mentioned countries suggest the following conclusions with regard to MTBFs:

- fiscal policy objectives and quantitative fiscal targets need to be articulated and defended at the highest level of government;
- the target levels of expenditure must be rigorously related to the macroeconomic prospects over the medium term;
- budget and forward estimates are better set in nominal terms to ensure that program managers respond to price changes;
- the framework should be based on clearly defined and fully costed policy proposals; and
- the MTBF should be accompanied by strengthened measures to review individual expenditure policies and their institutional delivery mechanisms.

MTBFs provide better, more transparent tools for formulating, assessing, and implementing the prevailing policy—but they will only be effective if there is a real, stable, transparent, and well-publicized commitment to fiscal control. MTBFs are only tools, however, not a technical cure for budget problems. They depend crucially on more fundamental improvements that should be fostered whether or not an MTBF is to be introduced: sustained political commitment, an appropriately phased introduction of improved forecasting and rigorous costing of programs, and disciplined budget management.

link, or coordination, the usefulness of budget documents is limited, and there is often inadequate provision made for operating and maintenance costs.

100. **Hong Kong SAR** provides a good example of the annual budget being cast in an aggregate medium-term framework. A Medium Range Forecast (MRF) is prepared and published as an annex to the budget speech.[69] The medium-range forecast involves projections for the budget year plus three years, and is used to assess the consistency of the prepared budget with target ranges for fiscal reserves over the four-year period, and with the government's guideline of keeping expenditure growth within the trend rate of growth of the economy over time. **Hungary** has also started to present its budget in the context of a three-year outlook for the budget and the economy, providing an outline of government policies for stabilization and sustained growth.[70] As noted, preparation of a forecast of fiscal aggregates for the budget year plus two appears to be an attainable goal for most countries. For many developing and transition economies, only an aggregate forecast will be feasible. This will nonetheless provide a useful picture of budget trends and a framework for considering medium-term changes in budget policy.

101. Best practice in advanced economies is that MTBFs are formalized in the budget process and are often explicitly required in budget system legislation. In **Germany**, the Law on Budgetary Principles, for instance, explicitly requires multiyear financial planning by all levels of government. To coordinate this task, a Financial Planning Council comprising the Minister of Finance (Chairman), the Minister of Economics, the state ministers responsible for financial affairs, and four representatives of municipalities was created in 1968 under Section 51 of this Law.

Fiscal sustainability

102. Current fiscal policies are unsustainable if they lead to an excessive buildup of public debt. However, judgements about excessive debt, and particularly about excessive debt-to-GDP ratios, are difficult to make. A common approach is to rely on a simple rule that specifies, for example, that the debt ratio cannot rise or exceed a specific limit. But such rules are quite arbitrary, and provide little guidance as to whether a particular debt ratio threatens macroeconomic stability, a loss of fiscal policy credibility, higher interest rate risk premia, etc. This being the case, assessments of fiscal sustainability have to be made on a country-specific basis, relying on particular knowledge about the implications of, and market reactions to, the government's past and future fiscal policies.

103. At a technical level, assessments of fiscal sustainability involve decomposing the change in the debt ratio into components reflecting the *primary balance* (the *overall balance* excluding interest payments), the interest rate on debt, the growth rate of the economy, and

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[69]See (http://www.info.gov.hk/fb/bdgt98/english/eindex.htm).

[70]See (http://www.meh.hu/default.htm).

the initial debt stock. From a policy perspective, attention is focused on the change in the primary balance required to meet the debt target over a specified time period. In making such assessments, it is important in the short to medium term that cyclical movements in economic and fiscal aggregates be distinguished from underlying structural changes. And in the longer term, it is important that policy commitments with a future financial impact be properly taken into account. Especially relevant in this regard are public pension programs, the costs of which will be adversely affected by population aging. One way of doing this would be to look at *unfunded public pension liabilities* alongside public debt in assessing sustainability, as is done by Chand and Jaeger (1996). This would be the first step toward more sophisticated approaches to assessing sustainability currently under development. One approach would involve the derivation of a complete government balance sheet, which would allow the focus of sustainability assessments to be shifted from debt to net worth and government solvency. Another approach would involve *generational accounting*, which assesses sustainability in terms of the distribution of taxes, expenditures, and fiscal adjustment across age cohorts. The information requirements of both of these approaches are large, and their use would be a best practice for only a few advanced economies.

Fiscal rules

3.1.2 Any fiscal rules that have been adopted (e.g., a balanced budget requirement and borrowing limits for lower levels of governments) should be clearly specified.

104. Fiscal rules are forms of agreement (usually in law) that restrict the fiscal policy action of government. Examples are the "golden rule" (that public borrowing must not exceed public investment), a balanced budget law, a limitation on the extent of borrowing from the banking system, or the criteria for fiscal convergence embodied in the Maastricht Treaty. It is necessarily true that any rule adopted by a government must be specified in some form. The issue that needs to be addressed with respect to transparency is the clarity with which the rule is defined. The golden rule, for instance is open to interpretation of what constitutes public investment and so needs to be supported by a clear budget classification. The Code therefore proposes that any fiscal rule adopted by a government be clearly explained, and that presentation and reporting standards with respect to performance against the rule be consistent with other elements of the Code.[71]

Macroeconomic framework

3.1.3 The annual budget should be presented within a comprehensive and consistent quantitative macroeconomic framework, and the economic assumptions and key parameters (e.g., effective tax rates) underlying budget estimates should be provided.

105. Fiscal policy must be seen in the context of its aggregate impact on the economy and in relation to other macroeconomic policies. Most countries have some formal methodology

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[71]Kopits and Symansky (1998) discuss fiscal rules in detail.

for macroeconomic forecasting and policy formulation, and advanced economies use sophisticated quantitative models to help frame the budget. However, economic circumstances, as well as political and administrative constraints, often limit the quality of such work and/or the extent to which it is effectively linked to the budget process in developing countries and countries in transition. It is proposed as a minimum standard that all governments include in budget documents a clear statement of the medium-term macroeconomic framework and the macroeconomic forecasts on which the budget is based, including the main underlying assumptions.

Separating existing commitments from new policies

3.1.4 Existing commitments should be distinguished from new policies included in the annual budget.

106. Clear identification of the costs of existing commitments and new government policies is a vital element of budget discipline.[72] It is proposed that all countries include with the annual budget a summary statement of the tax and expenditure policy changes being introduced and their expected fiscal effects. A good example of this is the reporting of budget measures in the **United Kingdom**, where not only a summary table of new budget measures and their estimated fiscal effects is provided in the budget, but there is also an annex setting out each measure in more detail.

Major fiscal risks

3.1.5 Major risks to the annual budget should be identified and quantified where possible, including the variations in economic assumptions and the uncertain costs of specific expenditure commitments (e.g., financial restructuring).

107. Budget estimates and the economic forecasts underlying the budget are subject to a variety of risks, including the effects of variations in the assumptions and parameters underlying the macroeconomic forecasts and individual program estimates, and uncertainty over the costs of specific expenditure commitments. It is proposed as a minimum standard that a statement of fiscal risks accompany the budget; risks should be quantified, where possible.[73]

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[72]The usage of the term "commitments" varies. Here it is used to mean all government expenditure obligations under current policies. In accounting, it has a more limited meaning, namely, a situation where the government is responsible for a future liability, based on an existing contractual agreement (e.g., a commitment entered into for the purchase of a capital item in the future). The obligation or liability will not arise until delivery of the item, but the government is contractually committed to meeting the obligation once delivery is made.

[73]There may be some instances where there are legitimate public policy reasons not to quantify a fiscal risk; for example, where to do so would result in disadvantage to the government in

(continued...)

This will facilitate assessment of the budget's reliability as a statement of expected fiscal outcomes. Box 13 provides more detail on the statement of fiscal risks. In general, the statement should **not** include potential liabilities of an implicit nature, such as possible bailouts, because of moral hazard concerns. Some of these potential risks raise the question of proper definition and clarity of the role of government vis-à-vis other sectors, which are addressed in Section I.

Box 13. Statement of Fiscal Risks

A statement should be presented with the annual budget, providing information on all material fiscal risks surrounding the estimates of revenue and expenditure contained in the central government budget. Materiality must be determined on a country-by-country basis, but is likely to involve reporting of all risks above some threshold size. Risks can be either positive or negative (i.e., can involve either an increase or decrease in revenue or expenditure). The statement should not include those risks which have been specifically allowed for in a budget contingency reserve. Where possible, risks should be quantified.

The statement should contain information on risks, broken down into the following categories:

(1) *variations in key forecasting assumptions*—the fiscal effects of variations in key assumptions underpinning the macroeconomic forecasts (e.g., the effect on the fiscal deficit of a 1 percent increase or decrease in GDP growth, inflation, interest rates, or the exchange rate from the central rate assumed in the budget forecast); and the fiscal effects of variations in key assumptions underpinning the budget forecasts of revenue and expenditure (e.g., a variation in the average tax rate, public sector wages, or the average number eligible for social assistance programs);

(2) *uncertainty about the size of specific expenditure commitments*—where provision has been made in the budget for expenditure on an item or activity but there is a greater-than-usual degree of uncertainty about the likely cost, the risk should be separately disclosed. For example, the government may have given an undertaking to depositors of specified distressed financial institutions that their deposits would be guaranteed. However, at the time of finalizing the budget, the eventual cost of this commitment is uncertain;

(3) *contingent liabilities*—these may include guarantees, indemnities, and warranties; uncalled capital (e.g., in international financial institutions); and litigation against the government; and

(4) *other items that have not been included in the budget because of the extent of uncertainty about their timing, magnitude, or eventuality*—for example, the government may have announced a general intention to introduce a policy change, the details of which have not been finalized sufficiently for inclusion in the budget.

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[73](...continued)
negotiations with third parties.

Budget Classification

3.2 Budget estimates should be classified and presented in a way that facilitates policy analysis and promotes accountability.

108. The Code proposes good practices concerning the classification and presentation of budget estimates in four areas: (1) data classification; (2) program objectives; (3) indicators of the government's financial position; and (4) the *accounting basis*.

Data classification

3.2.1 Government transactions should be on a gross basis, distinguishing revenue, expenditure and financing, and classifying expenditures on an economic and functional basis. In addition, expenditure should be classified by administrative category. Data on extrabudgetary operations should be similarly classified. Budget data should be presented in a way that allows international comparisons.

109. Budget transactions need to be capable of being reviewed from the perspective of their economic impact, the form of appropriation, administrative control, and their purpose. Classification to meet all of these needs is the foundation for budget analysis and presentation of the budget and final accounts. A complete classification system should allow reports to be generated for any of these purposes.

Comprehensiveness and compatibility with GFS

110. The budget classification for all countries should comprehensively cover the broadly defined budget (including all EBFs or special funds in the general government sector). It should be compatible with GFS standards for fiscal reporting in the sense that distinctions at a transactions level should permit generation of GFS-consistent reports. As a minimum standard, it is proposed that transactions be recorded on a gross basis, and revenue, expenditure, and financing classifications and subclassifications for all public accounts be consistent with the analytical distinctions in the GFS Manual.[74] In this connection, it should be emphasized that the GFS is a reporting standard for fiscal statistics and not an accounting or financial reporting standard. The differences are discussed in Box 14.

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[74]Although the GFS is not the only fiscal statistical reporting standard (the SNA and European System of Accounts (ESA) provide alternatives that are close in concept), the current (1986) manual provides the most generally accepted international point of reference for purposes of classification of fiscal statistics. The GFS Manual is currently under review, and a proposal to introduce an *accrual basis* accounting standard for fiscal reports is under active consideration. This change, however, would have a marginal effect on the underlying distinctions at a transactions level.

Box 14. Classification, Accounting, and Fiscal and Financial Reporting

Although there are some trends toward convergence, it is important to emphasize that financial reporting and fiscal reporting have different objectives. The underlying system of classifying budget transactions should be designed to meet both sets of objectives.

Financial reporting
Financial reporting by government on a cash or *modified cash basis* focuses on the financial performance of specific funds or the consolidated position of the reporting government. The aim in such systems has been limited to providing the legislature and the public with information on the financial performance of the entity, and how the financial position has changed over the reporting period. The *accounting system* does not need to record, for instance, the sources of domestic financing, nor do government cash basis accounts usually provide net transactions data (such as "net financing" or "*lending minus repayments*") identified in the GFS framework.

Fiscal reporting
The primary focus of fiscal reporting and the GFS framework, on the other hand, is to report government fiscal activities in a way that facilitates analysis of the impact of the government's fiscal operations on the rest of the economy. For example, transactions are classified according to economic category, and a standard aggregate measure of the fiscal position is derived that aims to capture the impact of the government's fiscal activities on the economy. The focus of the current GFS is on cash measures of the fiscal position, because these often best capture the impact on financial markets and the balance of payments, and facilitate analysis of the effects and desirability of different aggregate fiscal policies, and the balance between fiscal and monetary policy.

Classification and accounting systems
Both types of reporting are important for transparency. A well-designed classification of transactions, whether under a cash or accrual basis of recording and reporting, should meet both fiscal and financial reporting objectives. The chart below shows the linkages between separate elements of an integrated system—highlighting the need to take both elements into account in classification.

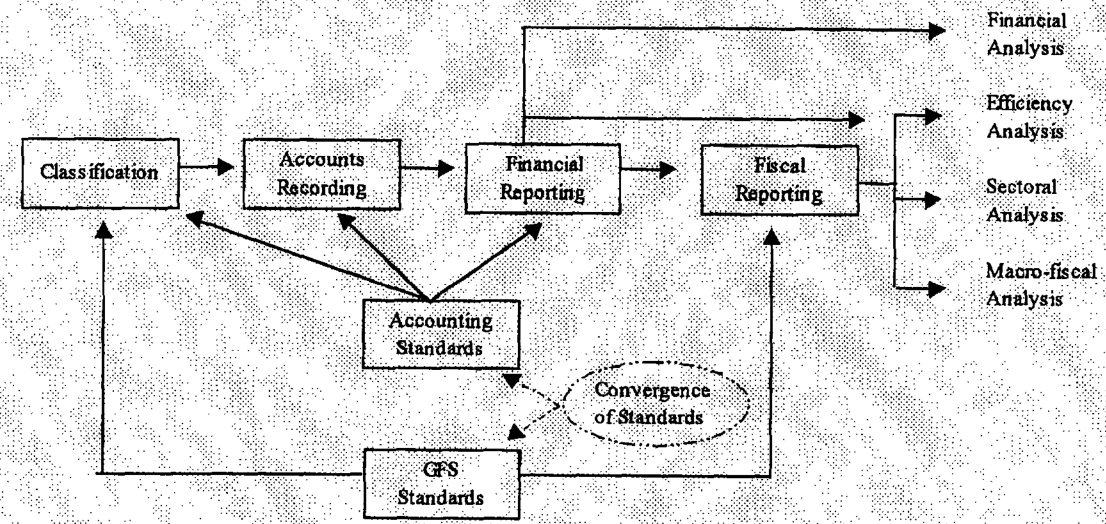
Toward convergence—accrual basis accounting
There has, however, been a growing recognition of the serious shortcomings of pure cash-based measures for both fiscal and financial reporting. Expenditure arrears, transactions in-kind, contingent liabilities, and other noncash operations have an economic impact before they are reported in cash- or modified cash-basis reporting systems. These effects are recognized in accrual basis systems and also need to be taken into account in macroeconomic policymaking. As indicated in Box 16, it is proposed that the GFS be changed from its present cash basis to an accrual basis of fiscal reporting.

For those countries that also adopt accrual basis accounts, financial reports and fiscal reports will converge in some respects. Accrual basis accounts, though introducing additional demands in terms of recognition of transfer of ownership, will also help governments assess their effectiveness and efficiency in utilizing the resources at their disposal. Cash measures have serious limitations from this perspective, including the inability to capture the effects of the noncash items referred to above. (See discussion of IFAC in Box 16.)

Several governments have moved to, or are investigating, a shift to accrual measures. IFAC (1998) notes that accrual accounting is used by governments in the **United Kingdom, Australia,** and **New Zealand**; by central government agencies in **Sweden**, and by local governments in many countries (e.g., **Malaysia, Switzerland,** and **Italy**). **Canada** uses modified accrual and is moving toward a full accrual system. Countries as diverse as **Mongolia**, **France,** and **Chile** are seriously investigating a shift to a modified accrual- or full accrual-based system.

It is not, however, suggested in the Manual that a change to an accrual basis is feasible for many countries in the near future. Accounting system design should be particularly conscious of both financial and fiscal analysis objectives, whatever basis of accounts recording and reporting is used.

Box 14 (concluded)



111. Aside from providing an analytical framework that facilitates assessment of the aggregate impact of government transactions on the economy, the GFS provides a widely accepted standard for an *economic classification* of revenue and expenditure and adopts the UN Classification of the Functions of Government (COFOG) as its *functional classification* framework. Adoption of these standards of classification facilitates international comparisons of budget statements and provides a basis for tracking the economic impact of the budget. Neither classification is intended to meet the needs of administrative or program control (see below).

Consistency with administrative accountability

112. The budget and accounts classification should also allow a clear tracing of responsibility for the collection and use of public funds. Most countries have relatively sound administrative classifications for this purpose, often to subdepartmental levels; in some countries, however, the classification does not allow detailed specification of administrative responsibilities. This is a particular problem in countries in transition, where under the former planning regime, the primary budget allocation was by broad functional category and allocations were made to individual spending units during the year. Many of these countries are, however, changing their classification to promote administrative accountability. For example, the 1998 budget in **Ukraine** introduced a basic GFS-consistent economic classification of expenditure and, for the first time, showed budget allocations by main spending agency. It is proposed, as a minimum standard, that all governments develop a

coherent administrative classification system that allows individual spending units to be publicly accountable for resources allocated to them.

Program objectives

3.2.2 A statement of objectives to be achieved by major budget programs (e.g., improvement in relevant social indicators) should be provided.

113. Transparency and accountability in government require that the budget and accounts be related to objectives and results of government activity, rather than simply to the items on which money is spent, as in traditional *line-item budgeting*. Modern budgeting tries to identify as far as possible the objectives of government activities and to measure *outputs and outcomes* in relation to these objectives. An important element of early efforts in this direction[75] is the classification of expenditures in "program," "subprogram," and "activity" categories, defined with increasing specificity at the more detailed levels in relation to a clearly stated set of objectives. Thus expenditures on a "public health" program could be linked to governments' broad aims of promoting preventative health care, and more specific objectives would be given in, say, an "antimalarial" subprogram. Classification of government activities by program is now widely practiced, and its further implementation will help improve transparency. However, it must be stressed that a *program classification*[76] supplements rather than replaces the traditional administrative classification discussed in the preceding section.

114. More recent efforts have emphasized increasing the authority and incentives for line managers to achieve agreed results. A number of countries are developing sophisticated systems of results-oriented budgeting and accounting. These efforts are very important for increasing transparency of strategic and operational choices made through government budgets. The Manual does not describe standards in this area at any level of detail.[77] The current emphasis is primarily on transparency at an aggregate level, and on putting in place a framework that is conducive to the provision of progressively more detailed information on the impact of budget decisions. Many of the techniques being applied in advanced economies

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[75]The **United States**, through its Planning, Programming, and Budgeting System (PPBS), represented the leading example in the mid-1960s.

[76]It should be noted that program classification is conceptually distinct from the GFS/COFOG functional classification, since government program objectives may be served by several functional areas (antimalaria, for instance, could require an educational component, an agricultural drainage component, and a health component). Nonetheless, in practice, some program classifications have been based on COFOG at the higher levels of categorization.

[77]The World Bank is developing a web site covering all aspects of public expenditure management among its member countries. Access to detailed work on these issues in the OECD and to individual country sites is provided through the OECD/PUMA web site (http://www.oecd.org/puma/links.htm).

require further development and place a heavy demand on administrative resources, and these requirements could not easily be met by developing countries or countries in transition. But all countries have the capacity to specify clear objectives for at least the major services provided by the government. The Code therefore calls for the budget to include a statement of objectives for major government programs (such as primary education and public health) in a form that is amenable to monitoring.

Indicators of the government's financial position

3.2.3 The overall balance of the general government should be a standard summary indicator of the government's financial position. It should be supplemented by other fiscal indicators (e.g., operational balance, structural balance, and primary balance) when economic circumstances make it inappropriate to base judgements about fiscal policy stance on the overall deficit alone.

115. The current GFS definition of overall balance of government,[78] though not adopted universally, provides a widely used reference point for fiscal analysis. It aims to identify those transactions of government that result in net borrowing from other economic sectors (and are "deficit or surplus creating" or "above the line"), and provides a focus for analysis of the size of the deficit/surplus and its components, as well as the sources of deficit financing (or "below-the-line" transactions). The balance concept thus links closely to the monetary accounts—and should be reconciled with them—and permits various kinds of alternative formulations by differing treatments of subcomponents of the overall balance.

116. While the use of the overall balance to analyze the government's fiscal position is a minimum standard, it has acknowledged weaknesses. However, these can be largely overcome by providing supplementary information or adjusting the balance to meet particular policy needs. Thus the *operational balance* (the overall balance minus the part of debt service that compensates debt holders for inflation) should be estimated when there is high inflation.[79] The *structural or cyclically adjusted balance* (which, in various forms, removes the effects of cyclical fluctuations or exogenous shocks from the overall balance) is used by a number of advanced countries and by the IMF in its *fiscal impulse* measure to show more clearly the discretionary policy stance of government.[80] The primary balance should be routinely reported for countries with substantial public debt or deteriorating debt dynamics.

117. Other concerns about the overall balance and by implication, the supplementary measures referred to above, fall into three categories. First, a general concern of the Code and

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[78]The term actually used throughout the current *GFS Manual* is "overall deficit/surplus."

[79]See Tanzi, Bléjer, and Teijero (1993).

[80]Issues regarding these and other concepts of the deficit are covered in Bléjer and Cheasty (1993).

the Manual, is that the conventionally defined budget may not capture all transactions of fiscal importance. In addition to identifying QFAs, the Manual suggests that in some circumstances it would be appropriate to calculate an augmented balance, as described in Box 15. Second, there is concern about the appropriate treatment of various subcomponents of the overall balance—particularly proceeds of asset sales and foreign aid receipts. And third, a more fundamental concern is that the cash basis of fiscal reports is inadequate and needs to be supplemented by an accrual basis.

118. Some aspects of the second concern are also related to the cash basis of fiscal reports. It is generally recommended, for instance, that the proceeds from asset sales (because of their lumpy and nonrecurrent nature) be treated as financing rather than revenue, negative capital expenditure, or regular net lending (Mackenzie, 1998). More generally, some countries identify an "underlying balance" net of "lending minus repayments," in an attempt to remove from cash- or modified cash-basis accounts the impact of all transactions in financial assets.

119. Another point of contention is the appropriate way to treat external aid flows. In the current GFS Manual, these are treated as "above the line" or deficit-reducing receipts. However, since these flows are not directly under the policy direction of the recipient government, some argue that they are better treated "below the line" as financing items. To indicate potential issues related to these receipts, in countries with large aid inflows it is common to identify the overall balance inclusive and exclusive of such flows.

120. Increasingly, however, the need to supplement cash basis reporting by at least some elements of accrual basis reporting is being recognized. A number of countries are adopting an accrual or modified accrual accounting standard (as indicated in Box 14). Though a cash basis overall balance will continue to be used by many countries for some time, the proposed revision of the GFS will use accrual basis standards for fiscal reports—in line with other economic statistics standards (see Box 16).

121. In addition to using the overall balance and supplementary measures for macroeconomic analysis, it is important that these concepts be clearly applied in presenting the annual budget to parliament and in public discussion. In many countries, budget estimates and final accounts reports are presented simply in a cash-accounting format (showing gross receipts and outlays). As a minimum standard, the overall balance should be presented in the budget documents with an analytical table showing its derivation from budget estimates.

The accounting basis

3.2.4 The annual budget and final accounts should include a statement of the accounting basis (i.e., cash or accrual) and standards used in the preparation and presentation of budget data.

Box 15. The Overall Fiscal Balance and Transactions Outside the Budget

A number of transactions that are in principle quantifiable, occur outside the budget and are not captured in the conventional measure of overall balance. It is recommended that all governments make a statement on the nature and extent of QFAs and that balance sheet transactions (such as bank recapitalization) often not recorded in *cash* or *modified cash* accounting reports be transparently recorded in the accounting system. Where such activities are extensive and quantifiable, but their magnitude and fiscal impact is not revealed in a summary measure of the fiscal balance, countries should present some form of "augmented" balance to give a clearer picture of the fiscal situation.

The augmented fiscal balance

Several proposals have been made regarding an augmented fiscal balance incorporating QFAs of central banks and PFIs. For example, Robinson and Stella (1993) suggest that central bank losses in the profit and loss account could be amalgamated into an adjusted fiscal deficit. Mackenzie and Stella (1996) note that the IMF sometimes in surveillance or program activities uses a broader "augmented" measure of the fiscal deficit to include net losses of the central bank and PFIs. Daniel, Davis, and Wolfe (1997) in the context of government restructuring of banks propose an augmented balance to incorporate the major quantifiable fiscal costs of bank assistance operations not included in current definitions of the overall balance. In the latter approach, though QFAs are only one potential element of restructuring costs, a central objective is to ensure that government support of banks through bond transfers or assumption of debt is shown as part of the deficit.

The Manual advocates that aspects of both proposals be incorporated in an operational concept of an augmented balance. Governments should, **wherever feasible, and where the magnitude is substantial,** quantify fiscal transactions not shown in budget accounts. The overall balance would remain as a basic statement, but a suitably qualified memorandum statement of an augmented deficit should also be presented to give a clearer picture of the true fiscal position. **A suggested base for an augmented deficit or surplus would consist of the overall balance (that is, the fiscal deficit or surplus derived from the budget or final accounts statements), plus any loss by the central bank, plus recapitalization activities not recorded**. On the latter point, the preference in the Manual is that accounting standards be set to require explicit treatment of recapitalization within the public accounts; but to the extent that this is not effected, such operations should be part of the augmented balance.

This estimate would need to be adjusted to allow for the different accounting bases typically used by central government and central banks, and to allocate central bank losses between member governments in a common currency area. Timing differences between the central government fiscal data and the prior period in which the central bank actually incurred the losses, as well as the timing of the economic impact of transactions related to recapitalization, would also need to be taken into account in interpreting the augmented balance.

PFIs and NFPEs as part of the balance

Inclusion of specific quantifiable QFAs of the central bank and PFIs in an augmented balance estimation is both complex and more contentious. The Manual proposes that this only be done where the magnitude is large, quantification is feasible, and double counting is avoided. Analysis of such QFAs is desirable to reveal the full effects and examine the efficiency of government policies, but may not be critical for aggregate analysis. Similar arguments would apply to possible inclusion of QFAs of NFPEs. Essentially, broad noncommercial aspects of NFPEs provide a justification for making the *public sector borrowing requirement* (PSBR) a focus of fiscal policy in addition to the overall balance of general government. Inclusion of QFAs of PFIs and NFPEs in an augmented balance, moreover, presents additional problems of an "arms-length" relationship and moral hazard. If these problems are extensive, it may be more appropriate to deal with them through intensive in-depth analysis of the enterprise sector and reexamination of the allocation of fiscal responsibilities.

Box 16. Fiscal Transparency and International Standards for Accounting and Fiscal Reporting

Efforts are being made to improve accounting and financial reporting standards by a number of governments. The work of IFAC and the proposed revision of the IMF's *GFS Manual*, together with this Code, are further steps toward development of standards that will help improve international comparability of data and contribute to improved fiscal transparency. It is important to distinguish the different objectives of these initiatives—and to coordinate work in all three areas as closely as possible.

IFAC-PSC Guideline *(http://www.ifac.org)*
The Public Sector Committee (PSC) of IFAC has released an exposure draft "Guidelines for Governmental Financial Reporting" aimed primarily at helping national governments prepare financial statements. The Guideline is not, in itself an accounting standard, but a statement of principles that will be the basis for international public sector accounting standards being developed by the PSC as the second stage of its standards project. The Guideline has defined the bases of accounting used by government in terms of four points on a spectrum: cash; modified cash; modified accrual; and accrual. At present, most governments operate cash or modified cash basis accounting systems. As discussed below, application of the Code would suggest that at least certain aspects of accruals standards could be applicable to financial reporting of most governments, even though their underlying system may remain predominantly cash-based.

GFS revision
The GFS is not an accounting or financial reporting standard, but a standard for analytical reporting of fiscal statistics; GFS looks at economic impact rather than accounting entity performance (see Box 14). Obviously it is desirable that government accounts classification and financial reporting standards be developed in a way that is compatible with the generation of such statistical reports, so that a single information system can meet both accounting and fiscal reporting needs.

As indicated in the *Government Finance Statistics Manual: Annotated Outline* (IMF, 1996b), it is proposed that the GFS be changed from its present cash basis to an accrual basis of reporting. This change recognizes the growing importance of accrual concepts for government accounting and aims to harmonize GFS with other international financial statistics systems (notably the SNA) that use accrual concepts. The proposed revision **would not require that countries adopt an accrual accounting system**: a staged transition is envisaged, and countries could adjust data from their cash accounts, or, in many cases use cash data where differences between cash and accrual are not substantial.

Fiscal transparency
The Code aims to support the application of GFS and international accounting standards, emphasizing (1) that all countries report on financial assets and liabilities—introducing some elements of a modified accrual standard; and (2) that all countries should aim to have an accounting system that can produce reliable reports on arrears. Such reports could be produced at a memorandum level by a cash system. The need to extend beyond this to a modified accruals system—in which accounts payable are automatically recorded as expenditure—should be determined by each country on a cost-benefit basis. These changes under the Code would also facilitate the development of more reliable fiscal reports for macroeconomic analysis.

122. There is no internationally accepted standard for government accounting or financial reporting, although work is underway in IFAC to develop such standards, as indicated in Box 16. The Code calls for governments to make an explicit statement on the accounting standards that apply to their budget and financial reports when these are presented to the legislature. It is a fundamental element of transparency that users of these reports know the accounting policies used in their production,[81] and this is proposed as a minimum standard. The basis of accounting (e.g., cash or accrual), the definition of the reporting entity, and any exclusions from coverage should be made clear. In addition, any recent revisions in accounting methodology and practices should be disclosed, together with an indication of the impact of the revisions on the fiscal aggregates. Advance notice should be given of any significant planned changes in accounting policies or practices.

Specification of Procedures for Budget Execution

3.3 Procedures for the execution and monitoring of approved expenditures should be clearly specified.

123. In the area of budget execution and monitoring, the Code proposes good practices relating to: (1) the accounting system; (2) procurement and employment; and (3) auditing.

The accounting system

3.3.1 A comprehensive, integrated accounting system should be established. It should provide a reliable basis for assessing payments arrears.

124. An effective accounting system is the basis for timely and reliable information on government activities; in many countries, greater emphasis needs to be placed on developing the accounting system. Accounting systems should be based on well-established internal control systems, allow for the capture and recording of information at the commitment phase and thereby generate reports on arrears, cover all externally financed transactions in a timely way, maintain records on *aid-in-kind*, and encompass balance sheet transactions, such as debt issued in connection with bank recapitalization.

Internal control systems

125. Sound control systems can make an important contribution to the reliability of fiscal and financial data, and are the starting point for ensuring the integrity of the recording and reporting process. While government systems vary widely, standards for internal control vary less. Broadly defined, internal control is a management tool used to provide assurance that

[81] "Accounting policies are the specific principles, bases, conventions, rules and practices adopted...in preparing and presenting financial statements" see paragraph 21, IFAC (1998.)

management's objectives are being achieved.[82] Responsibility for internal control therefore rests with the head of each individual government agency. However, a central government agency might be assigned responsibility for developing a governmentwide standard approach to internal control.

126. As defined by INTOSAI, the objectives of internal control systems are to promote orderly, economical, efficient, and effective operations; to safeguard resources against loss due to waste, abuse, mismanagement, errors, and fraud; to adhere to laws, regulations, and management directives; to develop and maintain reliable financial and management data; and to disclose that data in timely reports.[83] To be effective, internal controls must be appropriate, function consistently as planned throughout the period, and be cost-effective. A set of guidelines for internal control standards issued by INTOSAI is summarized in Box 17. It is proposed that internal control systems in all countries conform with INTOSAI guidelines.

Box 17. INTOSAI Guidelines for Internal Control Standards

INTOSAI has issued a set of general and detailed standards defining a minimum level of acceptability for a system of internal control.

General standards
- Specific control objectives are to be set for each activity of the organization, and are to be appropriate, comprehensive, reasonable, and integrated into the organization's overall objectives.
- Managers and employees are to maintain a supportive attitude to the standards at all times, and are to have integrity, and sufficient competence to meet the standards.
- The system is to provide reasonable assurance that the objectives for an internal control system will be met.
- Managers are to continually monitor their operations and take prompt remedial action where necessary.

Detailed standards
- Full documentation of all transactions and the control system itself to be provided.
- Transactions and events should be promptly and properly recorded.
- Execution of transactions and events should be properly authorized.
- Key responsibilities at different stages of a transaction should be separated among individuals.
- Competent supervision is to be provided to ensure control objectives are being achieved.
- Access to resources and records is to be limited to authorized individuals who are accountable for their custody or use.

[82]Under this broad definition, internal control also covers administrative controls (procedures governing decision-making processes) and accounting controls (procedures governing the reliability of financial records).

[83]See INTOSAI (1992).

127. An example of a governmentwide approach to internal control is that taken in **France** and in countries based on the French administrative system, where there is a clear distinction imposed by law between the public agency requesting the payment, a special unit of the ministry of finance that approves all expenses, and the accounting department of the ministry of finance that makes all payments. Other systems also separate the power to authorize commitments from that of making payments, but are more decentralized and emphasize the responsibility of management of each individual government agency for setting a sound control environment.

Assessment of arrears

128. In addition to being an indicator of serious flaws in fiscal management, arrears—on the payments or receipts side—are a major impediment to fiscal transparency. To the extent that arrears are unreported, the fiscal position is wrongly stated. Arrears also misrepresent the burden of budget deficit financing or taxation. Effective government accounting systems should provide enough information to assess the extent of arrears in payments or revenues.

129. Cash accounting in government understates the real government deficit to the extent that governments have substantial or persistent arrears in payment (e.g., suppliers, employees, and pensioners). Payment arrears are rarely an issue in advanced economies, but are only too common in developing countries and countries in transition (see Box 18). This problem arises more from budget policy failures than from accounting system weaknesses, but a robust accounting system does help to remedy the problem and avoid its recurrence.

130. The Code proposes that all governments have an accounting system that provides reliable information on overdue accounts payable or payment arrears. Such data would not be generated as a matter of course from a simple cash accounting system, but could be covered in supplementary reports. Therefore, all governments should move toward an accounting standard that facilitates end-period reports on accounts due for payment as well as reports on a cash-paid basis—whatever basis of accounting is used. A modified accrual or accrual system, as described in IFAC (1998), would achieve this objective, and may be appropriate for some countries. A cash basis for recording and reporting, supplemented with reliable memorandum reporting of arrears could, however, meet the requirements of the Code.[84]

131. On the revenue side, governments must also account for taxes and other revenues that have not been received on time.[85] For example, the stock of tax arrears can be substantial, but

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[84]See more detailed discussion of these issues in Potter and Diamond (1998); and IFAC (1998).

[85]Since government tax revenue is compulsory and unrequited, there are more difficulties in establishing recognition points to establish tax liability than on the expenditure side. IFAC (1998) notes a number of possible recognition points that could apply under an accrual system

(continued...)

Box 18. Stages of Payment and Payment Arrears

A payment arrears occurs when a bill or other obligation is due for payment but is not paid on or before the due date. To assess arrears, it is necessary to identify both when a bill is due for payment and whether or not actual payment has occurred. In a typical payment process, all accounting systems observe four basic stages:

- *commitment*: a prospective expenditure resulting from placement of an order, signing of a contract, or other agreement for the provision of goods or services;
- *verification*: confirmation by the authorized receiving agent that an ordered good or service has been received and, thereby, *recognition* of a liability;
- *payment issue*: issuance of a check or payment order to the supplier of a good or service or to meet a transfer obligation fallen due; and
- *cash payment*: payment of cash or transfer of funds to supplier or recipient's account after presentation and processing of check or payment order.

In advanced economies, it is customary for many suppliers of goods and services to provide between 30 and 60 days of credit from the verification to the payment-issue stage. That is, bills are "payable" after verification, and "due for payment" after the lapse of whatever credit period is allowed. Cash- and modified cash-basis systems record and report expenditures on a "payments issue" (or sometimes on a "cash-payment") basis, and particularly in less-developed systems—it is often difficult to get reliable estimates of earlier payment stages and of accounts due for payment. Accrual- and modified accrual systems record and report expenditures at the point of verification, and generally maintain more comprehensive records for all stages of payment. It is therefore easier to assess payment arrears from these latter systems.

it is difficult to know how much of the stock is actually collectible because many countries do not write off bad debts. As with the expenditure side, it is essential that the tax administration and accounting systems recognize and record payments due, and that they report the monthly and annual flows of unpaid taxes, penalties, and interest.[86] In support of this, the tax administration system should quickly identify stopfilers (registered taxpayers who fail to file on time)—especially large taxpayers—so that tax officials can contact taxpayers to determine why the taxes were not paid by the due date.

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[85](...continued)
and gives examples of recognition points for different taxes (paragraphs 517–28), and notes that "because of the differences in legislation and administrative systems across countries, it is possible that different countries will have different recognition points for similar taxes" (paragraph 524).

[86]Although offsetting arrangements are generally not recommended in government transactions, it is important that a unified approach be taken to assessment of tax liabilities. A single TIN and tax file for each taxpayer would permit such an assessment; if a taxpayer is in arrears for one tax and entitled to a refund from another tax, the refund should be used to offset the tax arrears.

Coverage of domestic and externally financed transactions

132. The accounting system should bring all public transactions to account in a timely way, and cover both domestic and externally financed transactions. In developing countries with large external aid inflows, it is not uncommon that many externally financed transactions are not captured by the government accounting system. Sometimes this occurs as a direct consequence of donor financing arrangements. For example, expenditure may be debited directly to donor agency accounts, and special accounting arrangements may be set up to ensure accountability to the donors, usually at the expense of transparency and accountability in the recipient country. All countries (with donor country support, where appropriate) should develop comprehensive and integrated accounting systems covering public transactions, irrespective of the source of financing. Cash-based systems can meet this objective, the principal requirement being that special measures be taken to ensure that all transactions are accounted for in a timely way.

Aid-in-kind

133. A related and very common weakness in accounting systems of many developing countries is that noncash aid is rarely fully recorded. This means that the public accounts do not reveal the true level of resources used nor their allocation by sector, organization, or region. An equally important failing is that assets thereby created or acquired are not recorded in a way that helps to identify long-term operations and maintenance needs. The transfer of such assets to the government when donor financing is completed can then lead to unexpected pressures on the budget. There are also problems with the timely recording and valuation of such assistance, and some measures should be taken to include aid-in-kind transactions to improve transparency. Cash basis systems are generally unsatisfactory as a means of tracking such transactions, and a full accrual based system would be needed to deal with nonfinancial assets in a fully integrated way. It is proposed that all countries maintain at least memorandum-level records of significant receipts of aid-in-kind, showing forecast receipts in the budget and audited receipts with the annual accounts.

Balance sheet operations

134. As highlighted by Daniel, Davis, and Wolfe (1997), many countries faced with bank restructuring use a combination of balance sheet operations (transfer of government bonds or assumption of debt) and QFAs (central bank loans) rather than direct budget support. In an integrated government accounting system, for instance under accrual or *modified accrual* standards, it would be necessary to reconcile the debt transactions with the operating accounts. The setting of clear international accounting standards for recording such noncash transactions covering all accounting bases would be highly desirable.

135. However, accounting for transactions in this way does not necessarily give a true reflection of their economic impact. Much of the economic effect may have occurred from prior actions, such as directed credit by the bank. Recapitalization may represent a recognition of accumulated past quasi-fiscal operations, so that the impact would have been understated in

the past but overstated when recapitalization takes place. This point notwithstanding, it is essential for transparency that the transaction be fully identified in the accounts. Reporting of any prior QFAs at the time of their occurrence would assist assessments of the macroeconomic impact at that time. It is also important that the accounts be carefully interpreted for fiscal analysis purposes.[87]

Procurement and employment

3.3.2 Procedures for procurement and employment should be standardized and accessible to all interested parties.

Procurement and tendering

136. Contracting for goods and services, particularly where large contracts are involved, must be open and transparent to provide assurance that opportunities for corruption are minimized and that public funds are being properly used. Similar considerations should apply to contracting out government services or management processes, and to privatization.[88]

137. Appropriate tendering mechanisms should be set up for contracts above some threshold size, and procurement regulations should give independent authority to a tender committee or board and require that its decisions be open to audit. Where services formerly provided within government are contracted out to the private sector, these procedures should be subject to the same or similar procurement regulations.[89] In this area, the OECD and the World Bank have helped a number of countries establish modern procurement systems, and good progress has been made in a number of countries in transition toward establishing sound and transparent procurement systems. **Poland**, for instance, developed a procurement law based on the United Nations Commission on International Trade Law (UNCITRAL) Model Law on Procurement of Goods, Construction, and Services,[90] with technical assistance from OECD/SIGMA. It operates a highly decentralized procurement system, with a central public procurement office responsible for developing rules and regulations. It is proposed that all governments establish clear regulations for procurement of goods and services, observing recognized international standards.

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[87]See discussion of financial reporting and fiscal reporting in Box 16.

[88]See paragraph 41.

[89]Guidelines on public procurement are available through the OECD/SIGMA web site (http://www.oecd.org/puma/sigmaweb/pubs/pbno3.htm), which cites relevant legislation under multilateral trade arrangements like the World Trade Organization's *Government Procurement Agreement* and the EU's *Procurement Directives,* which set legal obligations for national systems and practices.

[90]See (http://www.un.or.at/uncitral/en-index.htm).

Employment

138. Government procedures on employment within the public service should be clearly specified and open. Any public-service-wide recruitment and pay regulations should be published and made readily available. Vacancies should be advertised and filled through competitive, merit-based processes. In a number of the advanced economies, significant powers are being delegated to agency heads to set their own recruitment and—within varying limits—pay policies. Clarity and openness of procedures, of course, remain fundamental requirements.

Auditing

3.3.3 Budget execution should be internally audited, and audit procedures should be open to review.

139. Effective internal audit by government agencies is one of the first lines of defense against misuse and/or mismanagement of public funds.[91] It should be based on a sound internal control environment,[92] and not seen as a substitute for one. Checking by internal auditors also provides valuable material for review of financial compliance by external audit agencies. The existence and effectiveness of internal audit should be assured by requiring that internal audit procedures be clearly described in a way that is accessible to the public, and that the effectiveness of these procedures should be open to review by the external auditors. **Thailand** has issued a Code of Conduct for Internal Auditors,[93] which, though not enforceable by law, includes the possible sanction of forfeiture of membership of the Institute of Internal Audit of Thailand.

Fiscal Reporting

3.4 Fiscal reporting should be timely, comprehensive, reliable, and identify deviations from the budget.

140. Fiscal reporting standards relate to: (1) budget and extrabudgetary outturns; (2) final accounts; and (3) program results.

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[91]Internal audit is defined here as internal to the executive branch of government, external audit as external to the executive. Internal audit therefore covers both an audit of an agency by staff of the agency itself (ideally, reporting directly to senior management) and an audit of an agency by another agency (e.g., by an audit body under the control of the ministry of finance or the prime minister).

[92]See paragraphs 125–27.

[93]See (http://www.infonews.co.th/IIAT/ethics.htm).

Budget and extrabudgetary outturns

3.4.1 During the year, there should be regular, timely reporting of budget and extrabudgetary outturns, which should be compared with original estimates. In the absence of detailed information on lower levels of government, available indicators of their financial position (e.g., bank borrowing and bond issues) should be provided.

141. Effective fiscal management depends greatly on timely, reliable, within-year information on the government's fiscal position, which in turn allow appropriate responses to changing economic or fiscal circumstances.

Reconciliation with budget estimates

142. Actual financial results for the quarter or midyear should be compared to budget forecasts for that period and an estimate should be made in an analytical report of the potential impact on the full-year fiscal outturn. Where there are significant variations from the budget, factors causing the deviation (e.g., new policies, contingencies, parameter changes, changes in timing of revenue or expenditure) should be identified. For all reports, any unexplained discrepancy between government account records and bank account records should be disclosed.

Timeliness

143. The GDDS standard for statistical reporting on central government budgetary aggregates is to report on each quarter's outturn within the next quarter. This is a minimum standard for within-year statistical reports. It is also proposed that there be at least midyear reporting by central government to the legislature. Many advanced economies make formal quarterly or half-yearly reports to the legislature (some are required to do so by legislation), and some make monthly reports available to the public.[94]

General government coverage

144. Ideally, quarterly or midyear reports would cover the general government financial and fiscal position and provide a basis for assessing whether or not fiscal targets set in the budget can be achieved. It is recognized, however, that many governments will not be able to provide full coverage of lower levels of government. Comprehensive coverage of central government (including its EBFs) is called for by the Code. Where subnational fiscal issues are significant,[95] an aggregate summary statement of the fiscal position of subnational governments should also

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[94]Effective fiscal management, of course, will require more timely management reports within the government.

[95]See paragraphs 62–65.

be provided where practicable, if necessary using indicators of their fiscal position such as bank borrowing on bond issues.

Final accounts

3.4.2 Timely, comprehensive, audited, final accounts of budget operations, together with full information on extrabudgetary accounts, should be presented to the legislature.

145. Rigorous standards of coverage and reliability should be applied to final accounts, which should be audited by an external independent auditor and be presented within a reasonable time from year-end. As a rule, final accounts for each level of government will be audited and presented only within the relevant jurisdiction. The central government, however, should present a reliable picture of accounts from subnational government and summarize the fiscal outturn for general government. Final accounts should be reconciled with budget appropriations and a summary table presented showing the major causes of deviation from the original appropriation. Audited accounts should be fully reconciled with bank statements, and should be presented to the legislature after no more than a year. These requirements are proposed as a minimum standard.

Program results

3.4.3 Results achieved relative to the objectives of major budget programs should be reported to the legislature.

146. Paragraphs 113–14 propose that a statement of the objectives of major budget programs be reported. The outputs and outcomes achieved should be monitored and assessed against these objectives, and reported publicly.

IV. Independent Assurances of Integrity

147. A key requirement of fiscal transparency is that there be effective institutional mechanisms that allow the legislature and the public to be assured of the quality of fiscal data and information provided by the government.

Public, Independent Scrutiny of Fiscal Information

4.1 The integrity of fiscal information should be subject to public and independent scrutiny.

148. The Code proposes good practices relating to: (1) external audit; (2) the scrutiny of macroeconomic forecasts; and (3) the integrity of fiscal statistics.

External audit

4.1.1 A national audit body, or equivalent organization, should be appointed by the legislature, with the responsibility to provide timely reports to the legislature and public on the financial integrity of government accounts.

149. National audit bodies[96] are found in most countries, though precise forms and degrees of independence vary; new institutions need to be created for many countries in transition. In francophone countries, they are known as the *Cour des Comptes*, in Commonwealth countries, as the Audit Office; and in Latin American countries, as the *Contraloría General*. Their essential function is to uphold and promote public accountability. Their role can take on added importance in ensuring adequate public accountability as many governments move to devolve decision-making authority.

150. The core component of government auditing is the regularity audit. This covers attestation of financial accountability of individual agencies—involving evaluation of financial records—and the expression of opinions on financial statements; attestation of the financial accountability of the government as a whole; and audit of financial systems and transactions, and of internal control and audit functions—including an evaluation of compliance with regulations and statutes. In addition, many national audit offices play a valuable role in performance auditing: in auditing the economy, efficiency, and effectiveness of public agencies in achieving their stated objectives.

151. In completing a regularity audit, the auditor expresses a written opinion on his or her findings. An unqualified opinion is given when the auditor is satisfied in certain material respects, namely, that the financial statements have been prepared using acceptable accounting bases and consistently applied policies; that the statements comply with statutory requirements

[96] Also known as "supreme audit institutions." The national audit body is the highest level audit body in a country.

and regulations; that the view presented by the financial statements is consistent with the auditor's knowledge of the audited agency; and that there is adequate disclosure of all material matters relevant to the financial statements.

152. An important feature of national audit offices is that they not be under the control of the government of the day. Establishment of procedures independent of the executive for the appointment of the chief auditor, and for his or her removal from office is a common mechanism to assure independence. The chief auditor should be allowed to report directly to the legislature and the public. In a number of countries, however, this is not the case: chief auditors are appointed by the president or prime minister, and report to that official rather than to the legislature. The independence of chief auditors, in such cases, can be strengthened by making changes so that they are appointed by the legislature.

153. Where the chief auditor issues a qualified or adverse opinion, it is a minimum standard that there be mechanisms to ensure the findings are addressed. One mechanism would be a regulatory requirement that the audited agency respond to the findings publicly, in writing, and indicate the actions it will take in response. Another mechanism would be the presence of an active legislative committee (such as a public accounts committee), to review the public accounts, to consider the chief auditor's report and to hold the executive accountable for remedying deficiencies exposed through audit. For example, in the **United Kingdom**, the Public Accounts Committee reports its findings both to the Parliament and to the Treasury, and the Treasury must subsequently report back to the Committee on actions taken or not taken in response.

154. To ensure that the executive cannot render the national audit office ineffective by denying it adequate funding or by controlling its staffing—which is a common problem in many countries—there should be procedural mechanisms for providing a greater-than-usual degree of legislative oversight in the operation of the office. One mechanism would be to assign a legislative committee the responsibility for proposing the office's annual budget and for setting broad areas of priority for the office—while leaving the chief auditor some flexibility to initiate reports on any aspect of concern within their brief. It is important that the national audit office be given full access to all necessary records, documents, and personnel; legislative requirements to this effect would assist in obtaining the cooperation of audited entities.

155. As a minimum standard, it is proposed that the national audit office carry out its duties in a professional manner, consistent with internationally recognized auditing standards, such as those set by the INTOSAI (described in Box 19) or a regional body.[97] It should have the necessary core of professionally trained staff, and all staff should be required to exhibit independence in thought and action in the conduct of their duties. The work of the office should be subject to internal assurances of quality and independent appraisal.

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[97]See INTOSAI (1995).

Box 19. INTOSAI Auditing Standards

INTOSAI auditing standards consist of four parts: basic postulates, general standards, field standards, and reporting standards.

Basic postulates: the development of adequate information, control, evaluation, and reporting systems within the government will facilitate the accountability process; appropriate authorities should ensure the promulgation of acceptable accounting standards for financial reporting and disclosure relevant to the needs of the government; and each audit office should establish a policy on which INTOSAI standards, or other specific standards, it will follow in order to ensure its work is of high quality.

General standards: the individual auditor and the audit office must be independent of the executive, of the individual entity being audited, and of any political influence; they must possess the required competence; and they must exercise due care and concern in complying with INTOSAI auditing standards.

Field standards: the auditor should design regularity audit procedures to provide reasonable assurance of detecting errors, irregularities, and illegal acts that could have a direct and material effect on the financial statement amounts; the auditor should evaluate the reliability of internal control; and an objective of the regularity audit should be to provide assurance that the state budget and accounts are complete and valid.

Reporting standards: following each audit, the auditor should prepare a written opinion or report setting out the findings in an easy-to-understand form, including only information that is supported by competent and relevant audit evidence; and the auditor should be independent, objective, fair, and constructive (i.e., they should address future remedial action).

Scrutiny of macroeconomic forecasts

4.1.2 Macroeconomic forecasts (including underlying assumptions) should be available for scrutiny by independent experts.

156. The fiscal strategy and forecasts should be based on coherent and consistent medium-term macroeconomic forecasts.[98] Because of the sensitivity of the fiscal position to the assumptions made about key macroeconomic aggregates, an important element determining the credibility of the budget is the quality of the macroeconomic forecasts which underpin it.

157. It is proposed as a minimum standard that the macroeconomic forecasts and the economic assumptions on which the budget is based be open to formal scrutiny by independent experts. This could be achieved by making this information publicly available at the time the annual budget is presented to the legislature, presumably through inclusion in the documentation accompanying the budget.[99] This would allow independent assessment of the

[98]See paragraph 105 for discussion of the macroeconomic framework of the budget.

[99]In some countries, such as **Australia**, the macroeconomic model employed by the ministry (continued...)

macroeconomic framework of the budget and public debate over the realism of the budget. Transparency would be further served by publishing ex post assessments of the macroeconomic forecasts underlying previous budgets against the actual macroeconomic outcomes.

158. Some countries go beyond this and establish mechanisms for formal, public, quality reviews by independent macroeconomic experts. Others give an independent public agency the task of critiquing and reporting publicly on the quality of the macroeconomic forecasts. In the **United States**, the Congressional Budget Office, which reports directly to the legislature, prepares a complete set of macroeconomic and fiscal forecasts to be considered alongside those of the executive. A different approach has been taken in **Canada**, where the function of macroeconomic forecasting has effectively been contracted out; the consensus of private sector forecasts is used as the basis for government macroeconomic policy.

The integrity of fiscal statistics

4.1.3 The integrity of fiscal statistics should be enhanced by providing the national statistics office with institutional independence.

159. A national statistics office, set up under legislation that grants it technical independence in the compilation and publication of official economic and social statistics, provides an assurance of the quality and integrity of fiscal and other official statistics. In terms of fiscal statistics, such a body would be a focal point for the public availability of fiscal statistics and a link between international standards for statistical reporting and the public accounts. It would play a vital role by coordinating the collection and compilation of comprehensive fiscal data by official bodies and setting standards for fiscal reporting—generally covering all jurisdictions within the country. To promote integrity of fiscal statistics, all countries should observe the UN Fundamental Principles of Official Statistics (UN Statistical Commission, 1994), which are to help assure adequacy of statistical laws and regulations, institutions, and practices. To further promote these principles, the UN Statistical Commission has established a task force to develop a draft code of best practice. To put these principles into effect, it is essential that a country's national statistical office be established under a law that gives it technical independence and requires full cooperation of other agencies of government in compiling and presenting fiscal data.

160. To build confidence among users of official statistics, transparency of the practices and procedures of the national statistics office is also required. It is proposed that all countries meet the standards for data integrity and quality contained in the GDDS. These standards cover the dissemination of documentation on methodology and sources used in preparing statistics; the dissemination of component detail, reconciliation with related data, and statistical frameworks that support statistical cross-checks and provide assurance of

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[99](...continued)
or agency responsible for official forecasts is publicly available.

Box 20. The UN Fundamental Principles of Official Statistics

The following features of the UN Fundamental Principles are particularly important in fostering the integrity of fiscal statistics:

- official statistics are to be compiled and made available on an impartial basis by official statistical agencies;
- methods and procedures for statistical collection, processing, storage, and presentation of fiscal data are to be determined solely by the head of the statistical agency according to professional considerations; and
- statistical agencies are to be entitled to comment on erroneous interpretation and misuse of statistics.

reasonableness; the dissemination of the terms and conditions under which official statistics are produced, including those relating to the confidentiality of identifiable information; the identification of internal government access to data before release; the identification of ministerial commentary on the occasion of statistical releases; and the provision of information on revisions and advance notice of major changes in methodology.

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